

2003

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Employee Benefit Plans Industry Developments— 2003

Complement to AICPA Audit
and Accounting Guide *Audits
of Employee Benefit Plans*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA

Notice to Readers

This Audit Risk Alert, prepared by the AICPA staff, is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform.

This publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

The AICPA staff wishes to thank the members of the Employee Benefit Plans Expert Panel; the Employee Benefit Plans Audit Guide Revision Task Force; and the Office of Chief Accountant, Employee Benefits Security Administration of the U.S. Department of Labor for their contributions to this Audit Risk Alert.

2002-2003 Employee Benefit Plans Audit Guide Revision Task Force:

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Employee Benefit Plans Industry Developments—2003

How This Alert Helps You

This Audit Risk Alert is intended to help you plan and perform your employee benefit plan audits. The Alert addresses current industry developments and emerging practice issues and provides information on current auditing, accounting, and regulatory developments. Being armed with a sound understanding of these areas allows you, among other things, to perform your audits in a more efficient and effective manner, and to deliver greater value to your clients through audit and related services.

Industry and Economic Developments

As traditional pension plans continue to grow more scarce, employees are using their 401(k) accounts as their main source of retirement income. The past three years have seen 401(k) portfolios shrinking and pension plans becoming underfunded. This section discusses the economic environment, pension funding crisis, and other issues facing benefit plans today.

Economic Environment

In planning their audits, auditors need to understand the economic conditions facing the industry in which the client operates. Economic activities relating to such factors as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and the labor market are likely to have an impact on the entity being audited.

The United States economy is in a continued state of flux. According to the Commerce Department's figures, the economy was actually shrinking in 2001, showing that the United States was in a recession long before September 11. The events of that

day certainly cost the U.S. economy thousands upon thousands of jobs and somewhere between \$75 billion and \$100 billion in reduced output. And a number of industries, such as airlines and tourism, suffered tremendously and have not fully recovered. Undoubtedly, the impact of the terrorist attacks will ripple through the economy for some time.

Although the 2001 recession lasted six months longer than originally thought, it is still considered a mild recession by historical standards. Unfortunately, the recovery has been equally weak and is not typical of recoveries the country has experienced since World War II. In the past, job growth was sizable after a recession. This time, although unemployment fell to 5.6 percent in September of 2002, the trend for most of 2002 was flat. The government created most of the new jobs, and the number of jobs in the private sector actually decreased slightly. Employers are reluctant to hire new employees because of the tumbling stock market and uncertainty over the economy's health. The fourth quarter of 2002 saw the economy grow at a 1.4 percent annual rate. The historical average for economic growth at this stage of a recovery is in excess of 5 percent. The economy grew 1.6 percent in the first three months of 2003, weakened by war worries, high oil prices, and bad weather.

Stock Market Woes

The downward slide of the Dow Jones Industrial Average (DJIA), the National Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index, and the Standard & Poor's 500 Stock Index (S&P 500) that began in 2000 continued through 2002. Throughout the year, analysts were evaluating economic conditions and drastic declines in stock market indexes, comparing them to prior periods in an attempt to determine whether the economy had finally reached rock bottom. But the stock market kept surprising everyone with further declines that sent various indexes to record lows.

Many defined benefit pension plans have experienced market value declines to the extent that plan sponsors must now make

contributions (see the “Defined Benefit Plans’ Pension Funding Crisis” section of this Alert for an in-depth discussion). In addition, sponsors of defined contribution pension plans are rethinking company stock versus cash matching contributions and other plan design features.

Effect of Layoffs and Cost Reductions

The benefit plan administration area at a company can be especially volatile when it comes to layoffs. Significant layoffs can have a serious effect on an entity’s internal control and financial reporting and accounting systems. For instance, employees who remain at the company may feel overwhelmed by their workloads, may feel pressured to complete their tasks with little or no time to consider their decisions, and may be performing too many tasks and functions. The auditor may need to consider whether these situations exist and what their effect on internal control may be. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, provides guidance on the auditor’s consideration of an entity’s internal control in an audit of financial statements in accordance with generally accepted auditing standards (GAAS).

Additionally, the auditor may need to consider the possible effects that key unfilled positions can have on internal control. Entities that have had strong financial reporting and accounting controls could see those controls deteriorate due to the lack of employees. Layoffs as well as the current economic climate can also create additional exposure to possible internal fraudulent activities (for example, when an employee performs a job function that otherwise would be segregated). SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement caused by fraud. See the section “Consideration of Fraud in Employee Benefit Plan Engagements” in this Alert for further discussion of SAS No. 99.

You may want to consider these issues in planning and performing the audit and in assessing control risk. Remember that gaps in key positions may represent reportable conditions that should be communicated to management and the audit committee in accordance with SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325).

In addition, significant layoffs could result in a change in benefit plan activity (for example, decreased contributions or increased distributions) that should be considered in planning and performing the plan audit.

Some companies have chosen to reduce operating costs by decreasing/eliminating employer matching contributions or amending employee benefit plans to allow for payment of expenses from the plan instead of from the plan sponsor. There has been a trend toward defined contribution plans charging participants for expenses or paying expenses out of plan forfeitures. In addition, to reduce costs, health and welfare plans are increasing premium copayments or health insurance deductibles or lowering health coverage limits. Such changes in plan administration should be reviewed to determine whether they are in accordance with the plan document and should be considered in planning and performing the audit.

The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act). The Act dramatically affects the accounting profession and affects not just the largest accounting firms, but any CPA actively working as an auditor of or for a publicly traded company or any CPA working in the financial management area of a public company. The Act contains some of the most far-reaching changes that Congress has ever introduced to the business world. Although most of the provisions of this legislation are specific to auditors of public companies, even practitioners not performing audits may be affected by the Act. Therefore, all CPA firms should become familiar with the provisions of the Act.

Timetable

For a timetable of key actions to be taken in response to the Act and for information about what auditors need to know, go to www.aicpa.org/sarbanes/index.asp.

Major Provisions

Major provisions of the Act include:

- A new Public Company Accounting Oversight Board (PCAOB) of five members has been appointed and is overseen by the Securities and Exchange Commission (SEC). This new board will be funded by public companies through mandatory fees.
- Auditors of public companies will be required to register with the board. This includes auditors of employee benefit plans whose plan sponsors file Form 11-Ks with the SEC.
- The board has the authority to set and enforce auditing, attestation, ethics, and quality control standards for audits of public companies.
- The Act requires the board to include in auditing standards certain requirements, such as:
 - Retention of the audit working papers for a seven-year period
 - A concurring or second partner review of audit reports
 - A description in the auditor's report of the scope of the auditor's testing of the internal control structure and procedures of the issuer
- The Act requires inclusion in the auditor's report or in a separate report of (1) the findings of the auditor's testing of internal controls; (2) an evaluation of (a) whether the internal control structure and procedures include maintenance by the issuer of records that accurately and fairly reflects the transactions and disposition of assets and (b) whether the issuer's internal controls provide reasonable assurance that transactions are recorded in conformity with generally accepted accounting principles (GAAP), and that receipts and expenditures

are being made only in accordance with authorizations of management and directors; and (3) a description, at a minimum, of material weaknesses in internal controls.

- The board is empowered to inspect the auditing operations of public accounting firms and to investigate violations of securities laws, standards, competency, and conduct.
- The board can impose disciplinary or remedial sanctions for violations of the board's rules, securities laws related to public company audits, and professional accounting standards. The board will perform annual quality reviews (inspections) for the largest audit firms (more than 100 issuers); smaller firms must be inspected every three years.
- The Act restricts the consulting work auditors may perform for a public company it audits. Banned nonaudit services include bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, broker/dealer and investment banking services, legal or expert services unrelated to audit services, and other services the board determines by rule are impermissible. Nonaudit services not banned are allowed if preapproved by the audit committee.
- Audit committees of the company's board of directors are responsible for the hiring, compensation, and oversight of the independent auditor.
- Chief executive officers (CEOs) and chief financial officers (CFOs) are required to certify company financial statements, with criminal (up to 20 years) and civil (up to \$5 million) penalties for false certification. In the event of a restatement of financial statements arising from securities fraud, CEOs and CFOs must forfeit trading profits and bonuses received before the restatement. Presently, this requirement under section 302 of the Act does not apply to Form 11-K filings. It is unclear if certifications pursuant to section 906 of the Act apply to Form 11-K filings. SEC council should be consulted for this regulation.

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- Document altering or destroying in a federal or bankruptcy investigation is now a felony with penalties of up to 20 years. Key audit documents and e-mail must be preserved for five years. It is a felony, with penalties of up to 10 years, to destroy such documents. There is also a provision that requires retention of key audit documents, as defined by the SEC, for seven years.
 - The statute of limitations for the discovery of fraud is extended to two years from the date of discovery and five years after the act. (It was previously one year from discovery and three from the act.)

To read a detailed description of the Sarbanes-Oxley Act, go to www.aicpa.org/info/sarbanes_oxley_summary.htm.

Ramifications and Rulemaking

The ramifications of some of the provisions in the Sarbanes-Oxley Act will become known only as the SEC and the new PCAOB begin implementing the law. In response to the Act, the SEC has issued a number of rulings.

Cascade Effect

Of particular concern is just how far down the Act will cascade, affecting the nation's small and midsize accounting firms of nonpublic companies. A major concern is that the new legislation by Congress may become the template for parallel federal and state legislative or rule changes that directly affect both nonpublic companies that are subject to other regulations and the CPAs that provide services to them.

Section 209 of the Act states:

In supervising nonregistered public accounting firms and their associated persons, appropriate State regulatory authorities should make an independent determination of the proper standards applicable, particularly taking into consideration the size and nature of the business of the accounting firms they supervise and the size and nature of the business of the clients of those firms.

As we write, several states are moving forward with legislation that could result in additional burdens for CPAs and possibly conflict with federal laws. The AICPA and the state CPA societies are monitoring this situation closely and will continue to keep you informed.

Audit Engagement Changes Resulting From Sarbanes-Oxley

Currently, the AICPA Auditing Standards Board (ASB) is considering the Act's provisions and its audit implications. Issues being addressed include:

1. A possible amendment to SAS No. 96, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), to address the audit working paper retention provisions of the Act
2. Amendments to the attestation standards (Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements No. 10, *Attestation Standards: Revision and Recodification* [AICPA, *Professional Standards*, vol. 1, AT sec. 501) in light of the Act's provisions regarding internal control reporting
3. Possible changes to auditing and quality control standards to respond to the Act's provisions concerning audit partner rotation, concurring review partner reviews, and quality control
4. Possible changes to auditing standards in response to communication and reporting needs of audit committees

Your Professional Resource

To help you understand the ramifications of the Sarbanes-Oxley Act and to help you comply with its provisions, the AICPA is developing several resources, including the following:

1. A new toll-free number is available for any questions your firm or company may have about the legislation, how it

will be implemented, and how to comply. Call (866) 265-1977 and select the option that is most appropriate for your firm or company. You will receive a response within 24 hours.

2. The AICPA has established the “Sarbanes-Oxley Act/PCAOB Implementation Central” at AICPA Online at www.aicpa.org/sarbanes/index.asp to keep you up-to-date on important developments.
3. Periodic Web casts will be conducted to brief members on issues as they emerge, as well as short video clips and news alerts that will be sent to members through e-mail.
4. A one-hour CPE training course on the legislation has been developed.
5. Updates and information will be published in numerous newsletters and other communication channels, including AICPA Online, the *CPA Letter*, and the *Journal of Accountancy*.

Defined Benefit Plans’ Pension Funding Crisis

As the stock market has plummeted, so has the value of pension plan assets. Suddenly, entities are faced with the prospect of pouring money into underfunded pension plans. These contributions will reduce earnings, perhaps significantly. In addition, companies with underfunded pension plans face the risk of technically defaulting on the debt they carry. Thus, a going-concern problem can arise.

Impact on the Plan Sponsor

The funded status of most defined benefit pension plans has flipped from overfunded to underfunded since the beginning of 2000, and plan sponsor contributions may now be required. The decline of the equity markets is well recognized as a cause of the reversal, with the S&P 500 Stock Index declining 40 percent over that three-year period. Less recognized but of great impact is the lower interest rates used to present value the pension obligation. As a rule of thumb, for every 1 percent drop in the discount rate, the pension obligation increases by 15 percent to 20 percent.

The impact on a plan sponsor's financial statements has been dramatic, increasing pension expense (and thus lowering earnings per share), and in many cases causing an additional minimum liability to be recorded for the first time ever. When the market value of plan assets under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 87, *Employers' Accounting for Pensions*, falls below the accumulated plan obligation (APO), the deficiency, along with any prepaid pension cost, is recorded as additional liability, and for some companies, a portion of the additional liability is recorded as a reduction in shareholders' equity. The decreased equity affects the debt-to-equity ratio, which may cause debt covenant violations.

Illustrative Statement of Changes in Net Assets Available for Benefits With Negative Returns

With the continued decline in value of plan investments, many plans have investment losses. The following financial statement shows the presentation of investment losses on a statement of changes in net assets available for benefits.

ABC, Inc.
401(k) Employee Savings Plan
Statement of Changes in Net Assets Available for Benefits
(Modified Cash Basis)

	<i>Years ended December 31,</i>	
	<i>20X2</i>	<i>20X1</i>
Investment income (loss):		
Interest and dividend income	\$ 1,302,277	475,195
Net depreciation in fair value of investments	(5,206,577)	(1,888,439)
Other income—loan interest	15,488	9,805
Total investment loss	(3,888,812)	(1,403,439)
Contributions:		
Employee	6,777,195	5,489,673
Employer	2,483,755	865,479
Rollover	467,288	672,053
Total contributions	9,728,238	7,027,205
	5,839,426	5,623,766
Deductions from net assets attributable to:		
Benefits paid	3,796,126	2,947,410
Administrative expenses (note 4)	5,465	2,345
Total deductions	3,801,591	2,949,755
Net increase	2,037,835	2,674,011
Net assets available for benefits:		
Beginning of year	21,907,630	19,233,619
End of year	\$ 23,945,465	21, 907,630
See accompanying notes to financial statements.		

Investments in Limited Partnerships and Reporting Such Investments on Form 5500 and 103-12 Entities

Pension funds, especially those with large investment portfolios, are more frequently investing in limited partnership private equity funds, which may include hedge funds. These pooled investment funds are lightly regulated and not readily marketable, unlike registered investment funds, commonly known as mutual funds. Auditors should take special care in identifying when a plan invests in a limited partnership because it is not uncommon for such investments to be classified incorrectly (for example, as a registered investment company or other type of fund) on the schedule of investments provided by the custodian or trustee.

This trend of investing in limited partnerships and the recent scrutiny of accounting and disclosure of limited partnership investments in corporate financial statements have precipitated an issue about what employee benefit plan financial statements should disclose about a plan's investments in limited partnerships.

The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (EBP Guide) does not specifically address financial statement or Form 5500 reporting requirements for limited partnerships. Employee benefit plan financial statements report investments at fair value, which would include investments in limited partnerships. Such investments are not consolidated or accounted for on the equity method, as they might be in the plan sponsor's financial statements.

Other required disclosures for limited partnership investments are those applicable under AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*. SOP 94-6 requires disclosures about certain significant estimates and current vulnerability due to certain concentrations.

Consideration should be given to including the following disclosures:

- Description of the plan's ownership interests in the limited partnerships and a summary of investments owned by the partnership investments and the corresponding risk. A

riskier, more aggressive investment would warrant consideration of additional disclosure.

- If a related party relationship exists, the names of the other partners in the plan's partnership investments and their relationship to the plan.
- Methodology in which the partnerships allocate gains, losses, and expenses between the plan and the other partners.
- Related-party transactions with parties in interest related to the limited partnerships (including investment management fees paid).
- Additional capital commitment requirements.

Paragraph 7.57 of the EBP Guide addresses auditing procedures for limited partnerships when performing full scope audits. Auditors should take special care in performing limited scope audit procedures on limited partnership investments, as often the certifying entity does not have timely or accurate information regarding the amount and valuation of the plan's investment in the limited partnership. Although the auditor is not required to audit certain investment information when the limited scope audit exemption is applicable, further investigation and testing are required whenever the auditor becomes aware that such information is incorrect, incomplete, or otherwise unsatisfactory for the purpose of preparing the financial statements (see paragraph 7.62 of the EBP Guide.)

How a plan reports an investment in a limited partnership on Schedule H to the Form 5500 depends on the nature of the underlying assets of the partnership and whether the partnership elects to file directly with the Department of Labor (DOL).

Financial Statement Reporting and Form 5500 Filing Requirements for 103-12 Entities

DOL regulation 29 CFR 2520.103-12 provides an alternative method of reporting for plans that invest in an entity, other than a master trust investment account (MTIA), common/collective trust

(CCT), or pooled separate account (PSA), whose underlying assets include “plan assets” (within the meaning of DOL regulation 29 CFR 2510.2-101) of two or more plans that are not members of a related group of employee benefit plans. Making this determination can be complicated and may necessitate legal consultation.

Generally a 103-12 entity will operate based on its legal structure (according to its operating agreements) in the form of a financial services product such as a collective trust or a limited partnership. Typically audited financial statements are required by the entity’s operating agreement and are prepared in accordance with generally accepted accounting principles in a format following industry standards consistent with the entity’s operations. For example, a 103-12 entity that operates as a limited partnership would prepare financial statements in accordance with GAAP for limited partnerships.

103-12 entities are required to file the following (see paragraph A.56 of the EBP Guide):

- Form 5500
- Schedule A, Insurance Information
- Schedule C, Service Provider Information, Part I and II
- Schedule D, DFE/Participating Plan Information, Part II
- Schedule H, Financial Information (including the Schedule of Assets (Held at End of Year))
- Schedule G, Financial Transaction Schedules
- A report of the independent qualified accountant

Often the format of the financial statement schedules (for example, the Schedule of Assets) for the 103-12 entity prepared in accordance with industry standards are not consistent with format of the schedules as required by Form 5500 instructions. Form 5500 requirements should be considered when preparing additional information schedules to be attached to the 103-12 entity’s financial statements filed with the Form 5500.

Outsourcing of Certain Administrative Functions

Employee benefit plan sponsors have typically used third-party service providers in some capacity to assist in administering their plans. With the trend toward company downsizing and increased reliance on technology, many plan sponsors are increasingly turning to outsourcing as a way to reduce costs and increase efficiencies of administering employee benefit plans. Examples include recordkeeping and/or benefit payments or claims processed by outside service organizations, such as bank trust departments, data processing service bureaus, insurance companies, and benefits administrators.

Many plan sponsors and their employees may not be familiar with their fiduciary responsibilities regarding employee benefit plans. Auditors should refer plan sponsors to their plan legal counsel for interpretations of specific actions and how these may or may not be in accord with their fiduciary responsibilities.

SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, provides, among other things, guidance on the factors an independent auditor should consider when auditing the financial statements of a plan that uses a service organization to process certain transactions. Often, the plan does not maintain independent accounting records of transactions executed by the service provider. For example, many plan sponsors no longer maintain participant enrollment forms detailing the contribution percentage and the allocation by fund option; these amounts can be changed by telephone or over the Internet without any record. In these situations, the auditor may not be able to obtain a sufficient understanding of internal control relevant to transactions executed by the service organization to plan the audit and to determine the nature, timing, and extent of testing to be performed without considering those components of internal control maintained by the service organization. This understanding can be efficiently achieved by obtaining and reviewing a report prepared in accordance with SAS No. 70, if available. If a SAS No. 70 report is not available, see paragraph 6.14 of the EBP Guide for guidance.

The auditor should read the entire SAS No. 70 document to determine what was reviewed and tested and over what period and whether there are any instances of noncompliance with the service organization's controls identified in either (1) the service auditor's report or (2) the body of the document (where the results of testing are described). If the service organization's SAS No. 70 report identifies instances of noncompliance with the service organization's controls, the plan auditor should consider the effect of the findings on the assessed level of control risk for the audit of the plan's financial statements and, as a result, the plan auditor may decide to perform additional tests at the service organization or, if possible, perform additional audit procedures at the plan. In certain situations, the SAS No. 70 report may identify instances of noncompliance with the service organization's controls but the plan auditor concludes that no additional tests or audit procedures are required because the noncompliance does not affect the assessment of control risk for the plan.

The plan auditor should also read the description of controls to determine whether complementary user organizations controls are required (for example, at the plan sponsor level) and whether they are relevant to the service provided to the plan. If they are relevant to the plan, the plan auditor should consider such information in planning the audit. The plan auditor should consider the need to document and test such user organization controls. While the plan sponsor may have outsourced administrative functions to a third party, the plan sponsor still has a fiduciary duty to monitor the activities of the third party. Examples of such monitoring controls, which should be considered in planning and performing the audit, may include:

- Review of third-party service provider's SAS No. 70 report
- Fluctuation analysis or reasonableness review of periodic third-party service provider reports with reconciliations with and comparisons to client data
- Predetermined communication, escalation, and "follow-up" procedures in the event of an issue or problem

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- Periodic review of financial and control measures included in the third-party service provider contract
 - On-site visits to the third-party service provider
 - Annual reassessment of effectiveness of the third-party service provider relationship

What If the Service Organization Uses Another Service Organization to Perform Certain Functions?

A service organization may use another service organization to perform functions or processing that is part of the plan's information system as it relates to an audit of the financial statements. The subservice organization may be a separate entity from the service organization or may be related to the service organization. To plan the audit and assess control risk, the plan auditor may need to consider controls at the service organization and also may need to consider controls at the subservice organization, depending on the functions each performs. For further guidance on subservice organizations, see paragraph 6.17 of the EBP Guide and Chapter 5 in the AICPA Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (product no. 012772).

Going-Concern Issues for Plans

SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), as amended, provides guidance to auditors with respect to evaluating whether there is substantial doubt about the plan's ability to continue as a going concern. For financial reporting purposes, continuation of a plan as a going concern is assumed in the absence of significant information to the contrary. Ordinarily, information that significantly contradicts the going concern assumption relates to:

- The plan's ability to continue to meet its obligations as they become due without an extraordinary contribution by the sponsor or substantial disposition of assets outside the ordinary course of business.
- Externally forced revision of its operations, or similar actions.

During the course of the audit, the auditor may become aware of information that raises substantial doubt about the plan sponsor's ability to continue as a going concern. Although employee benefit plans are not automatically and necessarily affected by the plan sponsor's financial adversities, the auditor should address whether those difficulties pose any imminent, potential impact on the plan and should consider the sponsor's plans for dealing with its conditions. Due to the current economic climate, some plan sponsors are filing for bankruptcy, causing the plan to liquidate and pay out all of the participants. Plan expenses may increase if the costs of winding down the plan are paid out of plan assets (if permitted by the plan document).

SAS No. 59, as amended, states that the auditor has a responsibility to evaluate whether there is substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. The auditor considers the results of the procedures performed in planning, gathering evidential matter relative to the various audit objectives, and completing the audit to identify conditions and events that, when considered in the aggregate, create substantial doubt about the plan's ability to continue as a going concern for a reasonable period of time. As noted earlier, such conditions may include the need for an extraordinary contribution from the plan sponsor and/or the need to dispose of substantial assets outside the ordinary course of business. Other such conditions and events may include:

- The plan's inability to make benefit payments when they are due
- Plan merger or consolidation
- Debt restructuring
- Loan defaults
- The plan's inability to meet minimum funding requirements
- Bankruptcy of the plan sponsor (or participating employers in multiemployer plans)

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- A nontemporary decline in the market value of investments held by the plan
 - A significant increase in the cost of benefits without the ability to significantly raise contributions
 - Events that endanger the plan's ability to operate, such as if the plan no longer qualifies as a qualified plan

If the auditor determines that substantial doubt about the plan's ability to continue as a going concern does exist, an explanatory paragraph in the auditor's report is required regardless of the auditor's assessment of asset recoverability and amount and classification of liabilities. For example, if the sponsoring employer intends to terminate the plan within 12 months of the date of the financial statements, the auditor should include an explanatory paragraph in his or her report that discloses that fact. SAS No. 59 is amended to preclude the use of conditional language in expressing a conclusion concerning the existence of substantial doubt about the plan's ability to continue as a going concern in a going-concern explanatory paragraph.

The Health Insurance Portability and Accountability Act

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) established standards for the privacy and protection of individually identifiable electronic health information as well as administrative simplification standards. HIPAA includes protection for those who move from one job to another, who are self-employed, or who have preexisting medical conditions, and places requirements on employer-sponsored group health plans, insurance companies, and health maintenance organizations.

In December 2000 the final rules on standards for privacy of individually identifiable health information were published in the *Federal Register*. The rules include standards to protect the privacy of individually identifiable health information. The rules (applicable to health plans, health care clearinghouses, and certain health care providers) present standards with respect to the rights of individuals who are the subjects of this information, procedures for the exercise of those rights, and the authorized and re-

quired uses and disclosures of this information. These are the first-ever national standards to protect medical records and other personal health information. The new standards:

- Limit the nonconsensual use and release of private health information.
- Give patients new access to their records and let them know who else has accessed them.
- Restrict most disclosure of information to the minimum needed for the stated purpose.
- Establish criminal and civil sanctions.
- Establish requirements for access by researchers and others.

Providers will be required to obtain advance written consent from their patients to disclose information and to provide those patients with written information on their privacy rights.

The regulations became effective April 14, 2001; however, health care providers were not forced to fully comply with the changes until April 14, 2003.

In response to this regulation, many claim processors have updated and instituted a variety of confidentiality, indemnification, or business associates agreements to protect their organizations when third parties request claim information. In certain instances the auditor has been willing to sign such contracts but the third-party administrator has interpreted the new HIPAA regulations to not allow outside auditors access to the detail claims information. However, some believe that as long as the health information is protected by a privacy contract signed by the auditor, the third-party administrator should provide access to a plan's claim information for purposes of performing an audit of the plan's financial statements to be attached to the Form 5500 filing with the DOL.

On February 20, 2003 the security rules under HIPAA were finalized. The rules are effective for most health plans on April 21, 2005 (small health plans, as defined, will have until April 21, 2006 to comply).

If the auditor is unable to obtain access to records as a result of (1) not signing a confidentiality agreement or (2) a third party administrator's refusal to provide access under any circumstances, a scope limitation could result.

(See the discussion of confidentiality agreements in the section "Health and Welfare Benefit Plan Issues—Confidentiality, Indemnification, and Business Associates Agreements" of this Alert.)

GUST

GUST is an acronym for the following laws that have changed plan qualification requirements:

- General Agreement on Tariffs and Trade—Uruguay Round Agreements Acts (GATT)
- Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA)
- Small Business Job Protection Act of 1996 (SBJPA)
- Taxpayer Relief Act of 1997 (TRA '97)
- IRS Restructuring and Reform Act of 1998 (RRA '98)
- Community Renewal Tax Relief Act of 1997 (CRA)
- Community Renewal Tax Relief Act of 2000 (as added by Rev. Proc. 2001-55)

All plan documents, including those for prototype plans, must be amended to comply with the applicable legislative changes required by GUST. A prototype plan is typically a retirement plan prepared by a bank, securities firm, or other financial institution that may be adopted by an employer. Like all plans, prototype plans must be amended from time to time as required by changing legislation and regulations. Auditors should be aware that if plans are not restated in a timely manner to comply with GUST, the plan sponsor risks losing its plan's tax-qualified status.

Revenue Procedure 2001-55 extended the remedial amendment period to February 28, 2002 (if the period would have otherwise ended before then). Also extended to February 28, 2002, was the

time for adoption of a preapproved prototype plan or certification of intent to adopt such a plan in order to be eligible for the extension of the GUST remedial amendment period (later of December 31, 2002 or one year from receipt of a GUST opinion letter). Revenue Procedure 2002-73 further extended this time to the later of September 30, 2003 or the end of the 12th month after the date the sponsor receives a GUST opinion or advisory letter from the IRS, for amending preapproved plans to comply with GUST.

Regulatory Developments

PWBA Becomes the Employee Benefits Security Administration

Effective February 3, 2003, the DOL changed the name of the Pension and Welfare Benefits Administration (PWBA) to the Employee Benefits Security Administration (EBSA). According to EBSA Assistant Secretary Ann L. Combs, "This action helps us achieve our goal of improved public service by making the agency more recognizable to those we serve. We want to enable Americans to better identify the federal agency that assists them in understanding and receiving their benefits."

EBSA will continue to meet the ever-increasing demand to assist workers with their health and retirement benefits. The agency will continue its outreach activities to educate individuals and the business community about its programs, services, and relevant federal law, and help employers and service providers comply with their obligations under the law. During 2002, over 184,000 individuals contacted the agency for assistance.

The public may reach EBSA by using the existing telephone, e-mail, and Web site contacts for PWBA. The agency is initiating a new toll-free participant assistance number, (866) 444-EBSA (3272), a new address for electronic inquiries, www.askebsa.dol.gov, and a new address for its Web site, www.dol.gov/ebsa. To reduce paper-work and costs, employers and plans will not be required to modify existing summary plan descriptions to reflect the agency's name change.

2002 Form 5500 Series

The DOL, Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC) have released the 2002 Form 5500 return/reports, schedules, and instructions to be used by employee benefit plans for plan year 2002 filings. The IRS has also released the Form 5500-EZ return and instructions to be used by certain one-participant retirement plans for plan year 2002 filings.

The Form 5500 and Form 5500-EZ for plan year 2002 are essentially unchanged from 2001. Certain modifications have been made to reflect changes in the law or regulations, to improve forms processing and to clarify the instructions. Modifications include, among other things:

- Redesign of the signature areas on the Form 5500, Form 5500-EZ, and Schedules B, P, and SSA to highlight where to sign the forms;
- Addition of several new principal business activity codes for Form 5500, line 2d, and several new plan characteristics codes for lines 8a and 8b;
- Removal of lines 8c and 10c of Form 5500 and Schedule F as a result of IRS Notice 2002-24 that suspended the filing requirements for fringe benefit plans;
- Elimination of several lines from Schedules B and R due to the phasing out of certain rules under Internal Revenue Code section 412(l) and Employee Retirement Income Security Act (ERISA) section 302(d);
- Addition of lines 16a through 16c and 17a through 17e to Schedule E concerning employee stock option plans (ESOPs) maintained by S Corporations;
- Modification of Schedules H and I line 4a to highlight EBSA's Voluntary Fiduciary Correction Program (VFCP) and Prohibited Transaction Exemption (PTE) 2002-51; and
- Advising Schedule SSA filers who need to report more separated participants than Schedule SSA (page 2) allows that

the Social Security Administration requires that filers use additional Schedule SSA (page 2) as attachments.

The DOL's ERISA Filing Acceptance System (EFAST) continues to process the Form 5500 in two computer scannable formats: *machine print* and *hand print* (the questions are the same, only the appearance is different). Machine print forms are completed using computer software from EFAST approved vendors and can be filed electronically or by mail (including certain private delivery services). Hand print forms may be completed by hand, typewriter, or by using computer software from EFAST approved vendors. Hand print forms can be filed by mail (including certain private delivery services); however, they *cannot* be filed electronically.

The list of approved software vendors on the EFAST Web site is updated as software is approved for plan year 2002 filings. For assistance, filers may also contact EBSA's help desk toll free at (866) 463-3278.

Information copies of the forms, schedules, and instructions are available on EBSA's Web site at www.efast.dol.gov. Filers may also order forms and IRS publications 24 four hours a day, seven days a week, by calling (800) TAX-FORM (800-829-3676).

Department of Labor Amends EXPRO

On July 2, 2002, the DOL finalized an amendment to PTE 96-62, known as EXPRO, to streamline the process for parties to seek authorization from the DOL to engage in certain prohibited transactions. The exemption applies to certain prospective transactions between employee benefit plans and parties in interest where such transactions are specifically authorized by the DOL and are subject to terms, conditions, and representations that are substantially similar to exemptions previously granted by the DOL. The exemption affects plans, participants, and beneficiaries of such plans and certain persons engaging in such transactions.

PTE 96-62 requires that applicants demonstrate to the DOL that their proposed transactions are substantially similar to transactions in at least two exemptions previously granted by the depart-

ment within five years of their submission. The amendment provides applicants with more cases on which to base their transactions. The amendment to EXPRO also provides applicants with an alternate method of satisfying the program's requirements: Instead of having to cite as substantially similar two individual exemptions granted by the DOL within the previous five years, applicants may cite one individual exemption granted within the past 10 years and a transaction "authorized" under the EXPRO exemption within the past five years.

To date, over 200 EXPRO transactions have been authorized. EXPRO has significantly reduced the number of individual exemptions relating to routine transactions, thus allowing applicants to receive exemptions in a more timely fashion and often saving them the cost of going through the more formal process for exemptions.

For more information about EXPRO and the transactions authorized under the program, visit EBSA's Web site at www.dol.gov/ebsa.

Small Pension Plan Security Regulation

On October 19, 2000, the DOL published a final rule to improve the security of the more than \$300 billion in assets held in private-sector pension plans maintained by small businesses. In recent years, considerable public attention has focused on small plans' potential vulnerability to fraud and abuse. Although such circumstances are rare, the DOL decided it was appropriate to strengthen the security of pension assets and the accountability of persons handling those assets.

Historically, pension plans with fewer than 100 participants have been exempt from the requirement to have an independent audit of the plan's financial statements. This regulation is designed to safeguard small pension plan assets by adding conditions to the audit waiver requirement that focus on persons who hold plan assets, enhanced disclosure to participants and beneficiaries, and improved bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation.

Under the regulation, the administrator of an employee pension benefit plan that is required to complete Schedule I of the Form 5500 is not required to engage an independent auditor provided:

- At least 95 percent of the assets of the plan constitute “qualifying plan assets,” or
 - Any person who “handles” assets of the plan that do not constitute qualifying plan assets is bonded in accordance with ERISA section 412 and DOL Regulation 29 CFR 2580.412-6;
- and
- Certain required disclosures are made in the plan’s summary annual report (SAR).

According to the DOL, the vast majority of the assets of small plans are “qualifying plan assets.” The DOL believes that the plans that do not meet the 95 percent threshold will opt for the less expensive bonding alternative to avoid an independent audit of the plan’s financial statements.

Definition of Qualifying Plan Assets

For purposes of this regulation, the term *qualifying plan assets* means:

- Qualifying employer securities, as defined in ERISA section 407(d)(5) and the regulations issued thereunder;
- Any loan meeting the requirements of ERISA section 408(b)(1) and the regulations issued thereunder;
- Any assets held by any of the following institutions:
 - A bank or similar financial institution as defined in section 2550.408b-4(c);
 - An insurance company qualified to do business under the laws of a state;
 - An organization registered as a broker-dealer under the Securities Exchange Act of 1934; or

— Any other organization authorized to act as a trustee for individual retirement accounts under Internal Revenue Code section 408.

- Shares issued by an investment company registered under the Investment Company Act of 1940;
- Investment and annuity contracts issued by any insurance company qualified to do business under the laws of a state; and
- In the case of an individual account plan, any assets in the individual account of a participant or beneficiary over which the participant or beneficiary has the opportunity to exercise control and with respect to which the participant or beneficiary is furnished with, at least annually, a statement from a regulated financial institution describing the assets held (or issued) by such institution and the amount of such assets.

Disclosure Requirements

The exemption from the audit requirement for small pension plans is further conditioned on the disclosure of certain information to participants and beneficiaries. Specifically, the SAR of a plan electing the waiver must include, in addition to any other required information:

- Except for qualifying plan assets, as previously described, the name of each regulated financial institution holding (or issuing) qualifying plan assets and the amount of such assets reported by the institution as of the end of the plan year;
- The name of the surety company issuing the bond, if the plan has more than 5 percent of its assets in nonqualifying plan assets;
- A notice indicating that participants and beneficiaries may, upon request and without charge, examine, or receive copies of, evidence of the required bond and statements received from the regulated financial institutions describing the qualifying plan assets; and

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- A notice stating that participants and beneficiaries should contact the EBSA regional office if they are unable to examine or obtain copies of the regulated financial institution statements or evidence of the required bond, as applicable.

In response to a request from any participant or beneficiary, the administrator, without charge to the participant or beneficiary, must make available for examination, or upon request furnish copies of, each regulated financial institution statement and evidence of any bond required.

Effective Date

The amendments made by this final rule are applicable as of the first plan year beginning after April 27, 2001. Accordingly, this change applied to the 2001 year filings for fiscal year filers whose plan years begin after April 27, 2001, and the 2002 filings for calendar year filers.

Plan auditors should advise their small plan clients that they must indicate on Schedule I, Item 4k, whether they are claiming a waiver of the audit requirement.

Help Desk—See Appendix D of this Alert for a summary of the small pension plan audit waiver (SPPAW) in decision tree format.

DOL Guidance on Claims Regulation

On November 21, 2000, the DOL published in the *Federal Register* a final regulation that sets new standards for processing benefit claims of participants and beneficiaries who are covered under employee benefit plans governed by ERISA. The regulation may be found at the DOL's Web site at www.dol.gov/ebsa/regs/fedreg/final/2000029766.htm.

The new claims procedure regulation began to apply to some plans for new claims filed on or after January 1, 2002, and began to apply to group health plans on the first day of the first plan year beginning on or after July 1, 2002, but not later than January 1, 2003. The claims procedure regulation changes the minimum procedural requirements for the processing of benefit claims for all employee benefit plans covered under ERISA, al-

though the changes are minimal for pension and welfare benefits plans other than those that provide group health and disability benefits. For group health and disability benefit claims, the regulation substantially changes the procedures for benefit determinations. Among other things, it creates new procedural standards for initial and appeal-level decisions, new time frames for decision making, and new disclosure rights for claimants.

In response to many questions, the DOL has also published new guidance, in a Q & A format, to assist plans in bringing their benefit processing systems into timely compliance with the requirements of the claims regulation. This new guidance answers many of the frequently asked questions about the application of the claims regulation to group health and disability benefit plans. To the extent that the provisions of the regulation apply to other types of plans, the Q & A guidance applies to those plans also. The DOL anticipates providing additional guidance in the form of additional questions and answers, advisory opinions, or information letters as may be necessary to facilitate implementation of the requirements of the regulation. The views expressed in this publication represent the views of the DOL and may be obtained on the Internet at www.dol.gov/dol/ebsa or by calling the DOL toll free at (800) 998-7542 to obtain free printed copies.

EBSA Review of Plan Audits

The EBSA continues its ongoing quality review program to assess the quality of ERISA audits. EBSA staff review audit reports that are attached to Form 5500 filings as well as conduct on-site reviews of audit work papers.

In January 2003, the agency also began a nationwide study involving the on-site review of approximately 300 randomly selected sets of ERISA audit working papers. The primary objective of this review is to assess whether the level and quality of audit work being performed by Independent Qualified Public Accountants has improved as a result of actions taken by the DOL and the accounting and auditing profession since the performance of a similar study in 1997. That study disclosed that 19 percent of the audits pertaining to the 1992 filing year failed to comply with

one or more of the established professional standards, and 33 percent of the audit reports reviewed failed to comply with one or more of ERISA's reporting and disclosure requirements.

EBSA Outreach and Customer Service Efforts

The EBSA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 693-8360 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the EBSA's EFAST help desk at its toll-free number, (866) 463-3278.

In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to feature the current Form 5500, the EFAST processing system, and other agency-related developments. Questions regarding these outreach efforts should be directed to the Office of the Chief Accountant at (202) 693-8360. Practitioners and other members of the public may also wish to contact the EBSA at its Web site at www.dol.gov/dol/ebsa. The Web site also provides information on EBSA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Delinquent Filer Voluntary Compliance Program

Help Desk—While more common for pension plans, this program also covers delinquent contributions made to health and welfare plans.

The Delinquent Filer Voluntary Compliance (DFVC) Program is designed to encourage plan administrators to file overdue annual reports by letting them pay reduced penalties. Established in 1995, the program was revised in March 2002 to increase the incentives for delinquent plan administrators to voluntarily comply with ERISA's annual reporting requirements. Specifically, the DOL further reduced penalties under the DFVC program, and updated and simplified the rules governing participation in the program.

Program Eligibility

Eligibility in the DFVC program continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. For example, Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)), are not eligible to participate in the DFVC program because such plans are not subject to Title I.

Program Criteria

Participation in the DFVC program is a two-part process. First, file with EBSA a complete Form 5500 Series Annual Return/Report, including all schedules and attachments, for each year relief is requested. Special simplified rules apply to “top hat” plans and apprenticeship and training plans. Second, submit to the DFVC program the required documentation and applicable penalty amount. The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVC program shall not be paid from the assets of an employee benefit plan.

Penalty Structure

Reduced Per-Day Penalty. The basic penalty under the program was reduced from \$50 to \$10 per day for delinquent filings.

Reduced Per-Filing Cap. The maximum penalty for a single late annual report was reduced from \$2,000 to \$750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and from \$5,000 to \$2,000 for a large plan.

Per-Plan Cap. The revised DFVC program also includes a per-plan cap. This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The per-plan cap limits the penalty to \$1,500 for a small plan and \$4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no per-administrator or per-sponsor cap. If the

same party is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.

Small Plans Sponsored by Certain Tax-Exempt Organizations. A special per-plan cap of \$750 applies to a small plan sponsored by an organization that is tax-exempt under Internal Revenue Code section 501(c)(3). The \$750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if as of the date the plan files under the DFVC program, there is a delinquent annual report for a plan year during which the plan was a large plan.

Top Hat Plans and Apprenticeship and Training Plans. The penalty amount for top-hat plans and apprenticeship and training plans was reduced to \$750.

Updated and Simplified Procedures

The DOL also simplified and updated the procedures governing participation in the program. The changes are intended to make the program easier to use. For example:

- Plan administrators may use the Form 5500 forms for the year relief is sought or the most current form available at the time of participation. This option allows administrators to choose the form that is most efficient and least burdensome for their circumstances.
- The forms and penalty payment check should no longer be annotated in bold-red print identifying the filing as a DFVC filing.
- The program has been updated to conform to the annual reporting procedures under the computerized EFAST.
- The address where DFVC program remittances are submitted has been changed to DFVC Program, EBSA, P.O. Box 530292, Atlanta, Georgia 30353-0292. Submissions made to the old address will be returned to the filer.

IRS and PBGC Participation

Although the DFVC program does not cover late filing penalties under the Internal Revenue Code or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVC program have been satisfied.

Effective Date and Comments

The modifications of the DFVC program were effective upon the March 28, 2002, publication in the *Federal Register* of a notice announcing the modifications.

Questions about the DFVC program should be directed to EBSA by calling (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST Internet site at www.efast.dol.gov, or call the EBSA help desk toll free at (866) 463-3278.

DOL Issues Final Rules on Disclosure of Pension Plan “Blackout Periods”

On January 24, 2003, the DOL published final rules implementing a new federal law requiring 401(k) plans to give workers 30-day advance notice of “blackout periods” when their rights to direct investments, take loans, or obtain distributions are suspended. These final rules supersede interim final rules issued by the department on October 21, 2002.

Blackout periods typically occur when plans change recordkeepers or investment options, or add participants due to corporate merger or acquisition.

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002, giving the Secretary of Labor authority to promulgate rules and a model notice implementing the blackout notice provisions. The act requires that participants and beneficiaries be given a 30-day advance notice of a blackout period. When a blackout period affects a plan that includes employer stock as an investment option, the plan must also notify the corporate issuer of the employer stock, so corporate insiders are aware that they

may not trade employer securities or exercise options during the blackout. The law is effective for blackout periods occurring on or after January 26, 2003.

Under the final rules, 401(k) plan administrators must provide blackout notices that contain the reasons for the blackout, a description of the workers' rights that will be suspended, the start and end dates of the blackout period, and a statement advising workers to evaluate their current investments based on their inability to direct or diversify assets during the blackout period.

Changes made to the interim final rules in the final regulations include:

- Flexibility for plan administrators in describing the starting and ending dates of the blackout period;
- Clarification of situations that are not blackout periods, such as suspensions resulting from pending qualified domestic relations order determinations and actions by individual participants; and
- A special rule for issuers of company stock who are also the plan administrators.

Failure or refusal to provide the required notice may result in civil penalties. A second set of final rules issued by the DOL adopts the interim final rules that provide for civil penalties of up to \$100 per day per participant for plan administrators who fail or refuse to comply with the notice requirement.

The rules may be viewed at www.dol.gov/ebsa under "Laws and Regulations."

The DOL Introduces New Compliance Assistance Tool—Field Assistance Bulletins

On September 26, 2002, the DOL unveiled its first Field Assistance Bulletin (FAB) to publicize technical guidance provided to its field enforcement staff.

In the course of audits and investigations by EBSA field enforcement staff, difficult legal issues often arise. In an effort to provide

the regional office staff with prompt guidance, EBSA has developed a new vehicle for communicating technical guidance from the national office. FABs will ensure that the law is applied consistently across the various regions. They also will provide the regulated community with an important source of information about the agency's views on technical applications of ERISA. All FABs will be posted on EBSA's Web site and be available to the public.

Secretary of Labor Elaine L. Chao has made compliance assistance a top DOL priority. The FABs are the next step in EBSA's continuing compliance assistance program to educate and assist employers, plan officials, service providers, and others in achieving and maintaining compliance with ERISA. These efforts include working to foster self-regulation and oversight by offering programs that encourage voluntary compliance, such as the VFCP and the DFVC program. EBSA's compliance assistance program also includes outreach, new educational materials, and a dedicated Web page. FABs, as well as future bulletins, will be available at www.dol.gov/ebsa under "Compliance Assistance" and "Laws and Regulations."

The first FAB, Field Assistance Bulletin 2002-1, addresses the fiduciary considerations involved with the refinancing of an ESOP loan under ERISA section 408(b)(3).

Field Assistance Bulletin 2002-2 addresses whether the trustees of two related multiemployer plans were subject to ERISA's fiduciary standards when they amended the plan's trust agreements.

Field Assistance Bulletin 2002-3 addresses the fiduciary considerations regarding the use of agreements in which the service provider retains the "float" on plan assets.

Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA

The EBSA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are required to be remitted as soon as they can reasonably be segregated from an employer's general assets. DOL regulations require employers who sponsor pension

plans (both defined benefit and defined contribution) to remit employee contributions as soon as practicable, but in no event more than 15 business days after the month in which the participant contribution was withheld or received by the employer.

The regulation establishes a procedure by which an employer may obtain an extension of the 15-business-day limit for an additional 10 business days. This regulation does not change the maximum period for remittance of employee contributions to welfare plans as soon as practicable, but in no event more than 90 days after the day the contribution was withheld or received by the employer.

Failure to remit or untimely remittance of participant contributions may constitute a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of credit), regardless of materiality, and in certain circumstances may constitute embezzlement of plan assets. Additionally, such information should be properly presented on the required Form 5500 supplemental schedule of nonexempt transactions with parties-in-interest. GAAS requires that the auditor's report on financial statements included in an annual report filed with the DOL cover the information in the required supplementary schedules when they are presented along with the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements, or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See Chapter 11, "Party in Interest Transactions," of the EBP Guide for further discussion of prohibited transactions.

Late Remittances

Failure to remit or untimely remittance of participant contributions may constitute a prohibited transaction (either a use of plan assets for the benefit of the employer or a prohibited extension of

credit), regardless of materiality, and, in certain circumstances, may constitute embezzlement of plan assets. Such information should be reported on line 4a of either Schedule H or Schedule I of the Form 5500. Unless otherwise exempt, such transactions should also be reported on line 4d of either Schedule H or I; Part III of Schedule G (for large plans); and, if the plan is subject to the audit requirement, on the supplemental schedule of nonexempt transactions with parties in interest.

Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL's VFCP. Full compliance with the program will result in the DOL's issuance of a No-Action Letter and no imposition of penalties. In addition, applicants that satisfy both the VFCP requirements and the conditions of PTE 2002-51:

- Will be eligible for immediate relief from payment of certain prohibited transaction excise taxes imposed by the IRS. For more information, see 67 Federal Regulations 15062 and 67 Federal Regulations 70623 (November 25, 2002).
- Do not report the "corrected" transaction(s) as nonexempt transactions on line 4d of either Schedule H or Schedule I.
- Do not include such transaction(s) on the supplemental schedule of nonexempt transactions with parties in interest.

The EBSA's Web site contains useful information about the VFCP and an FAQ section that addresses issues such as how lost earnings may be calculated on delinquently remitted employee contributions.

Help Desk—For further guidance visit the EBSA's Web site at www.dol.gov/ebsa, in the "Spotlight on..." section, and click on VFCP Fact Sheet & FAQs, or see the section "DOL Voluntary Fiduciary Correction Program" under "Other EBSA Matters You Should Be Aware of" in this Alert.

It should be noted that the DOL's regional offices have conducted many investigations involving late remittances, often triggered by the reporting of late remittances on the plan's Schedule G attached to the Form 5500. It is not uncommon for the DOL to

find additional late remittances that were not reported on the schedule G once they begin their investigation. If a plan sponsor determines that they have late remittances, they should consider going back and reviewing all payroll remittances for the period under question to ensure they have a complete listing of all late remittances. The plan's auditor should also review the plan sponsor's procedures and consider additional testing, as applicable, to ensure completeness once it has been determined a late remittance has occurred since the auditor is opining on the schedule of nonexempt transactions.

Reporting Delinquent Participant Contributions on Schedule G

Often there is confusion when reporting a late deposit of employee deferrals on Part III of Schedule G. As there are no precise instructions, consider completing the following items:

- The employer is generally considered the “party involved.”
- The relationship is the “plan sponsor.”
- The description is “loan to employer in the form of late deposits of employee 401(k) deferrals.”
- The current value of asset is the amount of the lost interest.
- Other items should be left blank.

You may also wish to attach a statement to the Schedule G explaining the circumstances that led to the delinquent remittance(s), the steps taken to correct the situation, and an explanation about how lost earnings were calculated.

Help Desk—For questions or further information, contact the DOL Office of Regulations and Interpretations at (202) 693-8500.

Participant Loan Repayments Subject to Timing Rules

In Advisory Opinion 2002-2A, the DOL concluded that, while not subject to the participant contribution regulation (29 C.F.R. § 2510.3-102), participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit

plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

Given the similar treatment of participant contributions and loan repayments, the DOL has determined that it is appropriate to permit delinquent participant loan repayments to be corrected under the VFCP in the same manner as delinquent participant contributions.

Help Desk—For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500.

Other EBSA Matters You Should Be Aware of

This section discusses the following matters:

- 2002 Form M-1 Multiple Employer Welfare Arrangements
- DOL VFCP
- Direct Filing Entity (DFE) Enforcement Activities

2002 Form M-1 for Multiple Employer Welfare Arrangements

On December 13, 2002, the DOL published in the *Federal Register* the Year 2002 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). Although the format of the form has been improved to make it easier to read, the content is identical to the 2001 form.

Generally, MEWAs are arrangements that offer medical benefits to the employees of two or more employers, or to their beneficiaries. These arrangements may not include plans that are established or

maintained under collective bargaining agreements, by a rural electric cooperative, or by a rural telephone cooperative association.

The DOL has authority under HIPAA to require reporting of information about MEWAs. Administrators generally must file the one-page Form M-1 annually. The year 2002 form is generally due March 1, 2003, but administrators may request an automatic 60-day extension to May 1, 2003.

Administrators who fail to file the Form M-1, as required, are subject to penalties pursuant to DOL Regulation 29 CFR 2560.502c-5 of up to \$1,100 per day, continuing up to the date that the report is filed.

The Year 2002 Form M-1 is available by calling EBSA's toll-free publications hotline at (800) 998-7542 and is available on the Internet at www.dol.gov/dol/ebsa. Administrators may contact the EBSA help desk for assistance in completing this form by calling (202) 693-8360.

DOL Voluntary Fiduciary Correction Program

On March 15, 2000, the DOL adopted the VFCP, which helps plan officials quickly and completely correct certain employee benefit plan violations.

The EBSA has authority to bring civil enforcement actions and assess monetary penalties for ERISA violations. The VFCP lays out procedures, the types of transactions covered by the program, and acceptable corrective actions that do not require consultation or negotiation with the department.

Any plan official, sponsoring employer, or parties to affected transactions may apply to the appropriate EBSA regional office to voluntarily correct violations covered by the program. To qualify, applicants must have fully undone any prohibited transactions, restored any losses and profits with interest, and distributed any supplemental benefits owed to eligible participants and beneficiaries. In addition, a notice must be given to participants advising them of corrected violations.

The transactions eligible (a total of 14 specific transactions) for the VFCP involve:

- Delinquent employee contributions
- Certain prohibited loans
- Loans with inadequate collateral or security
- Certain improper sales or purchases, including prohibited transactions
- Improper valuation of assets that affect benefit calculations
- Payment of excessive or duplicative fees

Applicants who fully comply with all the terms and procedures of the VFCP will receive a No-Action Letter from EBSA and will not be subject to penalties. EBSA, however, does reserve the right to conduct investigations to determine truthfulness, completeness, and whether full correction was made.

Applicants who fail to fully correct fiduciary violations will be rejected and become subject to enforcement action and civil penalties. In addition, persons involved in pending investigations or criminal violations cannot take advantage of the program.

Information regarding the VFCP is available on the EBSA's Web site at www.dol.gov/dol/ebsa. Persons should telephone the EBSA regional office in their area with any questions about the application process. These telephone numbers may be found on the EBSA's Web site <http://askebsa.dol.gov>.

Direct Filing Entity Enforcement Activities

During the second half of 2002, the DOL began a program to review the accuracy and completeness of Form 5500 filings made by direct filing entities (DFEs). Initial reviews of the 1999 Form 5500 database have identified numerous technical deficiencies in DFE filings—namely, not properly following the instructions. Several of the more common errors include:

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- Incorrect completion of Schedule D, Part II, Information on Participating Plans (to be completed by DFEs). The schedule either:
 - Is not completed at all;
 - Fails to provide all of the participating plans employer identification numbers *and* three-digit plan numbers; or
 - Discloses participating plan information on an attachment in place of completing the schedule.
 - The failure of DFE investment information on Schedule H, Part I, to reconcile with Schedule D, Part I.
 - DFEs completing items on Schedule H that relate only to plan filings.

Enforcement letters have been sent to DFE filers requesting that the filings be corrected. Failure to correct the DFE filing may subject the participating plans' filings to rejection and further enforcement action by the EBSA.

DFE filers are encouraged to carefully read and follow the directions contained in the Form 5500 instructions regarding completion of the necessary schedules and information. Questions concerning completion of the Form 5500 may be directed to the EBSA help desk toll free at (866) 463-3278.

Audit Issues

Consideration of Fraud in Employee Benefit Plan Engagements

SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. SAS No. 99 supersedes SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and amends SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 230, "Due Professional Care in the Performance of Work"). SAS No. 99 establishes standards and

provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud as stated in SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 110.02, “Responsibilities and Functions of the Independent Auditor”). (SAS No. 99 also amends SAS No. 85, *Management Representations* [AICPA, *Professional Standards*, vol. 1, AU sec. 333].) SAS No. 99 is effective for audits of financial statements for periods beginning on or after December 15, 2002, with early application of the provisions permissible.

There are two types of misstatements relevant to the auditor’s consideration of fraud in a financial statement audit:

- Misstatements arising from fraudulent financial reporting.
- Misstatements arising from misappropriation of assets.

Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud. Second, circumstances exist—for example, the absence of controls, ineffective controls, or the ability of management to override controls—that provide an *opportunity* for a fraud to be perpetrated. Third, those involved are able to *rationalize* committing a fraudulent act.

The Importance of Exercising Professional Skepticism

Because of the characteristics of fraud, the auditor’s exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor’s belief about management’s honesty and integrity. Furthermore, professional skepticism requires an ongoing questioning of

whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

Members of the audit team should discuss the potential for material misstatement due to fraud in accordance with the requirements of SAS No. 99 (AU sec. 316.14-.18). The discussion among the audit team members about the susceptibility of the entity's financial statements to material misstatement due to fraud should include a consideration of the known external and internal factors affecting the entity that might (1) create incentives/pressures for management and others to commit fraud, (2) provide the opportunity for fraud to be perpetrated, and (3) indicate a culture or environment that enables management to rationalize committing fraud. Communication among the audit team members about the risks of material misstatement due to fraud also should continue throughout the audit. Examples of risk factors specific to employee benefit plans can be found in Appendix E of this Alert.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

SAS No. 22, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1, AU sec. 311.06-.08), provides guidance about how the auditor obtains knowledge about the entity's business and the industry in which it operates. In performing that work, information may come to the auditor's attention that should be considered in identifying risks of material misstatement due to fraud. As part of this work, the auditor should perform the following procedures to obtain information that is used (as described in SAS No. 99 [AU sec. 316.35-.42) to identify the risks of material misstatement due to fraud:

1. Make inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed. (See SAS No. 99 [AU sec. 316.20-.27].)

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2. Consider any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit. (See SAS No. 99 [AU sec. 316.28-.30].)
 3. Consider whether one or more fraud risk factors exist. (See SAS No. 99 [AU sec. 316.31-.33], and the Appendix to SAS No. 99)
 4. Consider other information that may be helpful in the identification of risks of material misstatements due to fraud. (See SAS No. 99 [AU sec. 316.34].)

In planning the audit, the auditor also should perform analytical procedures relating to revenue with the objective of identifying unusual or unexpected relationships involving revenue accounts that may indicate a material misstatement due to fraudulent financial reporting, for example, for employee benefit plans investment returns that vary from industry benchmarks for the investment type.

Considering Fraud Risk Factors. As previously indicated, the auditor may identify events or conditions that indicate incentives/pressures to perpetrate fraud, opportunities to carry out the fraud, or attitudes/rationalizations to justify a fraudulent action. Such events or conditions are referred to as “fraud risk factors.” Fraud risk factors do not necessarily indicate the existence of fraud; however, they often are present in circumstances where fraud exists.

SAS No. 99 provides fraud risk factor examples that have been written to apply to most enterprises. Appendix E of the Alert contains a list of fraud risk factors specific to employee benefit plans.¹ Remember, fraud risk factors are only one of several sources of information an auditor considers when identifying and assessing risk of material misstatement due to fraud.

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1. (See also Appendix I of the EBP Guide for fraud risk factors specific to employee benefit plans.)

Identifying Risks That May Result in a Material Misstatement Due to Fraud

In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in accordance with the requirements of SAS No. 99 (AU sec. 316.19-.34). The auditor's identification of fraud risks may be influenced by characteristics such as the size, complexity, and ownership attributes of the entity. In addition, the auditor should evaluate whether identified risks of material misstatement due to fraud can be related to specific financial statement account balances or classes of transactions and related assertions, or whether they relate more pervasively to the financial statements as a whole. Certain accounts, classes of transactions, and assertions that have high inherent risk because they involve a high degree of management judgment and subjectivity also may present risks of material misstatement due to fraud because they are susceptible to manipulation by management.

For employee benefit plans, such accounts include valuation of nonmarketable investments; for pension plans the accumulated plan benefit obligation; for health and welfare plans the benefit obligations, including those for postretirement, postemployment, claims incurred but not reported, and claims payable. For multi-employer plans, estimates also include the amount and collectability of contributions receivable and withdrawal liabilities.

A Presumption That Improper Revenue Recognition Is a Fraud Risk

Material misstatements due to fraudulent financial reporting often result from an overstatement of revenues (for example, through premature revenue recognition or recording fictitious revenues) or an understatement of revenues (for example, through improperly shifting revenues to a later period). Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. (See SAS No. 99 [AU sec. 316.41].) For employee benefit plans, this risk is primarily related to investment income resulting from inappropriate investment valuation.

A Consideration of the Risk of Management Override of Controls

Even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur, and accordingly, the auditor should address that risk (see SAS No. 99 [AU sec. 316.57]) apart from any conclusions regarding the existence of more specifically identifiable risks. Specifically, the procedures described in SAS No. 99 (AU sec. 316.58-.67) should be performed to further address the risk of management override of controls. These procedures include (1) examining journal entries and other adjustments for evidence of possible material misstatement due to fraud, (2) reviewing accounting estimates for biases that could result in material misstatement due to fraud, and (3) evaluating the business rationale for significant unusual transactions.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

Auditors should comply with the requirements of SAS No. 99 (AU sec. 316.43-.45) concerning an entity's programs and controls that address identified risks of material misstatement due to fraud.

Examples of programs and controls for employee benefit plans include those examples detailed in Appendix B of the EBP Guide and also may include the following:

- Board of directors or committee oversight of the plan with qualified and stable members
- Identification and education of the individuals who have fiduciary responsibility for the plan
- Access to qualified ERISA counsel
- Use of reputable outside service providers, such as investment custodians, investment managers, recordkeepers, claims administrators, or paying agents
- Appropriate oversight and monitoring of outside service providers

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- Plan administrator-maintained independent records; periodic checks of information provided to the investment custodian
 - Preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan
 - Segregation of duties related to benefit payments, contributions, investment transactions, and loans
 - Process for approval of transactions with parties-in-interest
 - Periodic “audit” of methodology and assumptions used in actuarial valuations
 - In multiemployer plans, payroll audits of contributing employers to verify employer contributions receivable

The auditor should consider whether such programs and controls mitigate the identified risks of material misstatement due to fraud. After the auditor has evaluated whether the entity’s programs and controls have been suitably designed and placed in operation, the auditor should assess these risks, taking into account that evaluation. This assessment should be considered when developing the auditor’s response to the identified risks of material misstatement due to fraud.

Responding to the Results of the Assessment

SAS No. 99 (AU sec. 316.46.-67) provides requirements and guidance about an auditor’s response to the results of the assessment of the risks of material misstatement due to fraud. The auditor responds to risks of material misstatement due to fraud in the following three ways:

1. A response that has an overall effect on how the audit is conducted—that is, a response involving more general considerations apart from the specific procedures otherwise planned (see SAS No. 99 [AU sec. 316.50]).
2. A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed (see SAS No. 99 [AU sec. 316.51-.56]).

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3. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur (see SAS No. 99 [AU sec. 316.57-.67]).

Appendix I, paragraph I.08 of the EBP Guide describes specific auditor procedures that could be performed for employee benefit plans.

Evaluating Audit Evidence

SAS No. 99 (AU sec. 316.68-.78) provides requirements and guidance for evaluating audit evidence. The auditor should evaluate whether analytical procedures that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud. The auditor also should consider whether responses to inquiries throughout the audit about analytical relationships have been vague or implausible, or have produced evidence that is inconsistent with other evidential matter accumulated during the audit.

At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of auditing procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. As part of this evaluation, the auditor with final responsibility for the audit should ascertain that there has been appropriate communication with the other audit team members throughout the audit regarding information or conditions indicative of risks of material misstatement due to fraud.

Responding to Misstatements That May Be the Result of Fraud

When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. See SAS No. 99 (AU sec. 316.75-.78) for requirements and guidance about an auditor's response to misstatements that may be the result of fraud. If the auditor believes that misstatements are or may be the result of fraud, but the effect of the misstatements is not material to the fi-

nancial statements, the auditor nevertheless should evaluate the implications, especially those dealing with the organizational position of the person(s) involved.

If the auditor believes that the misstatement is or may be the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should:

1. Attempt to obtain additional evidential matter to determine whether material fraud has occurred or is likely to have occurred, and, if so, its effect on the financial statements and the auditor's report thereon.²
2. Consider the implications for other aspects of the audit (see SAS No. 99 [AU sec. 316.76]).
3. Discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and the audit committee.³
4. If appropriate, suggest that the client consult with legal counsel.

The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to the audit committee or others with equivalent authority and responsibility. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

2. See Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508), as amended, for guidance on auditors' reports issued in connection with audits of financial statements.

3. If the auditor believes senior management may be involved, discussion of the matter directly with the audit committee may be appropriate.

Communicating About Possible Fraud to Management, the Audit Committee, and Others

Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. See SAS No. 99 (AU sec. 316.82) for further requirements and guidance about communications with management, the audit committee, and others.

Documenting the Auditor's Consideration of Fraud

SAS No. 99 (AU sec. 316.83) requires certain items and events to be documented by the auditor. Auditors should comply with those requirements.

Practical Guidance

The AICPA Practice Aid *Fraud Detection in a GAAS Audit: SAS No. 99 Implementation Guide* (product no. 006613kk) provides a wealth of information and help on complying with the provisions of SAS No. 99. Moreover, this Practice Aid provides an understanding of the differences between the requirements of SAS No. 99 and SAS No. 82, which was superseded by SAS No. 99. This Practice Aid is an Other Auditing Publication as defined in SAS No. 95, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 150). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply SASs.

Limited-Scope Certifications

The auditor may be engaged to perform a full-scope audit of the financial statements of an employee benefit plan in accordance with GAAS. Alternatively, ERISA section 103(a)(3)(c) allows the plan administrator to instruct the auditor not to perform any auditing procedures with respect to investment information prepared and certified by a bank or similar institution or by an insurance carrier that is regulated, supervised, and subject to periodic examination by a state or federal agency who acts as trustee or custodian. The election is available, however, only if the trustee or custodian certifies both the *accuracy* and *completeness* of the information submitted. Certifications that address only accuracy or

completeness, but not both, do not comply with the DOL's regulation, and therefore are not adequate to allow plan administrators to limit the scope of the audit. This *limited-scope* audit provision does not apply to information about investments held by a broker/dealer or an investment company. However, some broker/dealers and investment companies have established separate trust companies that will provide a limited scope certification. The DOL has noted instances where limited scope audits were performed when the financial institution did not qualify.

The auditor should note that certifications received from third-party administrators or service organizations may not qualify for the limited scope audit. In addition, if a limited-scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, separate individual plan certifications from the trustee or the custodian should be obtained for the allocation of the assets and the related income activity to the specific plan. The exemption applies only to the *investment* information certified by the qualified trustee or custodian, and does not extend to participant allocations, contributions, benefit payments, or other information, whether or not it is certified by the trustee or custodian. Thus, except for the investment-related functions performed by the trustee/custodian, an auditor conducting a limited-scope audit would need to include in the scope of the audit functions performed by the plan sponsor or other third-party service organizations, such as third-party welfare plan claims administrators or third-party savings plan administrators, if circumstances necessitate. The nature and scope of testing will depend on a variety of factors, including the nature of the functions being performed by the third-party service organization, whether a SAS No. 70 report that addresses areas other than investments is available, if deemed necessary, and, if so, the type of report and the related results. (See chapter 6 of the EBP Guide for a discussion of SAS No. 70.) The limited-scope audit exemption is implemented by 29 CFR 2520.103-8 of the DOL's Rules and Regulations for Reporting and Disclosure under ERISA. The limited-scope exemption does not exempt the plan from the requirement to have an audit.

Guidance on the auditor's report and responsibilities for this type of limited-scope audit is provided in paragraphs 7.61 and 13.25 through 13.29. Exhibit 5-1 in Chapter 5 of the EBP Guide summarizes the conditions that generally allow for limited-scope audits in decision tree format.

Self-Directed Investments—The DOL's Alternative Method of Reporting Participant-Directed Brokerage Window Investments

Plan sponsors of participant-directed defined contribution plans continue to allow participants to expand their control over investment decisions, through self-directed investments,⁴ sometimes referred to as self-directed brokerage accounts. These features allow participants to select any investment they choose without oversight from the plan administrator or investment committee. The only limitation is the availability of the desired investment through the plan's service provider, which generally is a securities broker-dealer or is a broker-dealer that has an alliance with the plan's service provider. The self-directed feature is often in addition to a more traditional array of risk diverse mutual funds and other investment option choices. Often plan sponsors may charge participants' fees to provide this investment feature and may also require a minimum balance to be invested.

While self-directed accounts should be viewed as individual investments for auditing and reporting purposes, the instructions to Form 5500, Schedule H, "Financial Information," permit aggregate reporting of certain self-directed accounts (also known as participant-directed brokerage accounts) on the Form 5500 and related schedule of assets.

For Form 5500 reporting, investments made through participant-directed brokerage accounts may be reported as a single line item on the Schedule H of the Annual Return/Report Form

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4. This is different from participant-directed investment fund options. Participant-directed investment fund options allow the participant to select from among various available alternatives and to periodically change that selection. The alternatives are usually fund vehicles, such as registered investment companies (that is, mutual funds); commingled funds of banks; or insurance company pooled separate accounts providing varying kinds of investments, for example, equity funds and fixed income funds.

5500 rather than by type of asset on the appropriate line item for the asset category (in Parts I and II of Schedule H), for example, common stocks and mutual funds, provided the assets are *not*:

- Loans
- Partnership or joint-venture interests
- Real property
- Employer securities
- Investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction

This Form 5500 reporting creates an issue with investment reporting in plan financial statements because GAAP requires certain reporting and disclosures. The following table summarizes the differences between the Form 5500 alternative reporting for participant-directed brokerage account investments and GAAP that may raise issues for auditors when obtaining brokerage window investment information.

<i>Form 5500— Alternative Reporting</i>	<i>GAAP—Required Reporting and Disclosures</i>
<ul style="list-style-type: none">• Certain investments and related income (see above) made through participant-directed brokerage accounts may be shown as single line items on Schedule H.• Certain investments listed on the Schedule of Assets (Held at End of Year) may be shown as a single line item.	<ul style="list-style-type: none">• Identification of investments representing 5 percent or more of plan net assets in the plan's footnotes. (See paragraph 3.28g of the EBP Guide.)• Reporting of investment income, exclusive of changes in fair value, in the statement of changes in net assets or the footnotes. (See paragraph 3.28b of the EBP Guide.)• Reporting of net appreciation/depreciation by investment type in the plan's footnotes. (See paragraph 3.25a of the EBP Guide.)

In addition, plan auditors may experience difficulty in obtaining brokerage window investment information by individual investment categories (such as common stocks and mutual funds) and

brokerage window investment income (such as net appreciation/depreciation by type) from plan service providers. In plans subject to the limited scope audit provisions of ERISA, the investment certification may provide investment amounts only in total, not for the individual investments. However, brokerage window investments are not considered a fund or a pooled separate account subject to other reporting requirements. Individual investment information is needed by plan administrators and auditors for the valuation of investment assets in the plan and for audit testing and disclosure purposes in accordance with GAAP and GAAS. Therefore, it is important for plan administrators, recordkeepers, and service providers to maintain these records for audit and financial reporting purposes.

It is also important to note that the single line reporting of participant-directed brokerage window investment assets on the Form 5500 is allowed provided the investment assets are not loans, partnership or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction.

This alternative method of reporting participant-directed brokerage window investments does not relieve fiduciaries from their obligation to prudently select and monitor designated plan investment options and brokers.

What Are Derivatives? How Do I Audit Them?

As plan investments continue to lose value, many plan sponsors are turning to derivatives as tools to manage the risk stemming from fluctuations in foreign currencies, interest rates, and other market risks, or as speculative investment vehicles to enhance earnings. Derivatives get their name because they derive their value from movements in an underlying⁵ such as changes in the

5. Paragraph 2.09 of the Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* defines an *underlying* as a specific interest rate, security price, commodity price, foreign exchange rate, index of prices, or rates, or other variable. An underlying may be a price or rate of an asset or liability, but it is not the asset or liability itself.

price of a security or a commodity. Examples of common derivatives are options, forwards, futures, and swaps. Employee benefit plans that use derivatives to manage risk are involved in hedging activities. Hedging is a risk alteration activity that attempts to protect the employee benefit plan against the risk of adverse changes in the fair values or cash flows of assets, liabilities, or future transactions. SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance on auditing investments in debt and equity securities; investments accounted for under Accounting Principles Board (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*; and derivative instruments and hedging activities. Paragraph 7.53 of the EBP Guide discusses the objectives of auditing procedures applied to derivative instruments and related transactions. Paragraph 7.54 discusses the auditing procedures to be applied to derivative instruments and hedging activities.

The unique characteristics of derivatives instruments and securities, coupled with the relative complexity of the related accounting guidance, may require auditors to obtain special skills or knowledge to plan and perform auditing procedures. SAS No. 92 is intended to alert auditors to the possible need for such skill or knowledge. Also, see the AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* for further guidance on auditing such instruments (product no. 012520).

Help Desk—Chapter 3 of the AICPA Audit and Accounting Guide *Audits of Investment Companies* includes brief descriptions of certain financial instruments that may be helpful when such investments are used by employee benefit plans. Some derivative financial instruments commonly found in employee benefit plans include call options, forward foreign exchange contracts, futures contracts, put options, and synthetic guaranteed investment contracts (GICs). (For more information regarding current accounting and financial reporting for synthetic GICs, see paragraphs 7.44 and 7.45 of the EBP Guide.)

Health and Welfare Benefit Plan Issues—Confidentiality, Indemnification, and Business Associates Agreements

In response to the new HIPAA regulations (see the section “The Health Insurance Portability and Accountability Act” in this Alert), claim processors may be updating and instituting a variety of confidentiality, indemnification, or business associates agreements to protect the organization when third parties request claim information. Many third-party administrators that process health and welfare claims for plan administrators do not have a report on their internal control prepared in accordance with SAS No. 70, as amended. It may be necessary for the auditor to request access to the third-party administrator’s records to test claim transactions in order to obtain sufficient evidence to achieve the audit objectives. In many instances, a third-party administrator will request that the auditor enter into a confidentiality, indemnification, or business associates agreement signed by the auditor, third-party administrator, and plan sponsor relating to the claims testing.

Auditors need to take special care in reviewing these agreements. Often the auditor may not agree with certain language in the agreement, resulting in delays in the audit while mutually agreeable language is determined. Many of the representations are very broad. The agreements generally require that the auditor hold the claim processor harmless from any actual or threatened action arising from the release of information without limitation of liability. In addition, the agreements may require the auditor to hold the client harmless as well. This last indemnification will most likely contradict provisions in the engagement letter between the auditor and the client. Auditors need to keep in mind that the testing of claims at a third-party administrator could be delayed as a result of the request to sign such an agreement and should plan the timing of the audit accordingly. Before entering into any confidentiality agreements, the agreement should be reviewed by the auditor’s legal counsel. If the auditor is unable to obtain access to records as a result of not signing a confidentiality agreement, a scope limitation could result.

AICPA Peer Review Developments—Recurring Deficiencies Found in Employee Benefit Plan Audits and Commonly Overlooked Audit Areas

The AICPA, working with EBSA, has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans, and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of license. Some common recurring deficiencies noted by the AICPA Peer Review Board⁶ in its review of employee benefit plans include:

- Inadequate testing of participant data
- Inadequate testing of investments, particularly when held by outside parties
- Inadequate disclosures related to participant-directed investment programs
- Failure to understand testing requirements on a limited-scope engagement
- Inadequate consideration of prohibited transactions
- Incomplete description of the plan and its provisions
- Inadequate or missing disclosures related to investments
- Failure to properly report on a DOL limited-scope audit
- Improper use of limited scope exemption because the financial institution did not qualify for such an exemption
- Inadequate or missing disclosures related to participant data
- Failure to properly report on and/or include the required supplemental schedules relating to ERISA and the DOL

6. Taken from the *AICPA 2001/2002 Peer Review Board Oversight Task Force Report and Comments*.

The EBP Guide provides guidance concerning areas where the Peer Review Board noted deficiencies.

Commonly Overlooked Audit Areas

Specific areas often overlooked in employee benefit plan audits include the following.

Eligible Compensation. Plan documents specify the various aspects of compensation (for example, base wages, overtime, and bonuses) that are considered in the calculation of plan contributions for defined contribution plans and in the determination of benefits in a defined benefit plan. Testing of payroll data should address the determination of eligible compensation for individual employees and comparison of the definition of eligible compensation used in the calculation to the plan document. Since this process is generally not included in the payroll testing of the plan sponsor or in Type II SAS No. 70 reports, a comparison of eligible compensation per the plan document to eligible compensation used in plan operations is required.

Payroll Data. Reliance is often placed on testing of payroll performed in conjunction with a corporate audit; however, these procedures, which generally include only high level analytics with limited or no documentation of the control environment or performance of substantive procedures, are not sufficient in scope to opine on the benefit plan. Often payroll processing is outsourced to an outside service provider that may have a SAS No. 70 Type I report, which provides a description of procedures and controls, but does not have a SAS No. 70 Type II report, which also includes testing of the procedures and controls, and can be used to reduce the scope of substantive testing. Paragraph 10.05 of the EBP Guide describes procedures the auditor should consider to test payroll in conjunction with the plan audit.

Service Organizations and SAS No. 70 Reports. Most employee benefit plans use service organizations (for example, bank trustees, insurance companies, or benefits administrators) to process transactions and maintain plan records. Often SAS No. 70 Type II reports are obtained and used by the auditor to reduce the amount of substantive testing required. Auditors often do not

perform or document their evaluations of the extent of the evidence provided by the report regarding the effectiveness of controls for particular financial statement assertions and of its effect on audit strategy, including determination of the nature, timing, and extent of substantive tests for particular audit objectives. An evaluation of user organization controls that are contemplated in the design of the service organization's controls and recommended in the service organization's description of controls in the SAS No. 70 report should also be performed.

For service organizations that do not issue a current Type II SAS No. 70 report, the working papers should contain sufficient documentation of the auditor's understanding of the control environment at the service organization and the results of the auditor's evaluation of the effectiveness of control policies and procedures sufficient to support the planned reliance approach. See Chapter 6 of the EBP Guide for further discussion of internal controls.

Understanding Investments. Plan investments represent the majority of assets held by a benefit plan. Benefit plans invest in a wide variety of investments and investment vehicles, some of which are not easily identified by review of the investment firms. It is important for auditors to gain an understanding of the types of investments the plan holds to determine the proper auditing procedures and accounting and reporting implications. This understanding can be obtained through (1) discussions with plan management, investment advisers, or custodian/trustees and (2) review of investment agreements, minutes of investment committee meetings, and other documentation. Chapter 7 of the EBP Guide provides a description of various investments and related audit procedures.

Limited Versus Full-Scope Audits. Under DOL regulations, certain assets held by a bank, trust company, or similar institution or by a regulated insurance company and related investment information do not have to be audited provided the institution certifies the information. All noninvestment activity of the plan such as participant allocations, contributions, benefit payments, and expenses are subject to audit. See EBP Guide paragraphs 7.61 and 13.26 for limited scope procedures and reporting.

Allocation Testing for Defined Contribution Plans. One of the objectives of auditing procedures applied to individual participant accounts of a defined contribution plan is to provide the auditor with a reasonable basis for concluding whether net assets and transactions have been properly allocated to participant accounts in accordance with the plan documents. Each type of participant account activity during the year (for example, contributions, income allocations, expenses allocations, and forfeiture allocations) should be taken into consideration in the determination of auditing procedures. In a limited scope audit, the allocation of investment income to individual accounts is not certified by the trustee/custodian and must be tested by the auditor, taking into consideration reliance on a SAS No. 70 Type II report, if available. See Chapter 10 of the EBP Guide for further discussion of auditing participant data.

New Auditing, Attestation, and Other Guidance

Presented below is a list of auditing, attestation, and quality control pronouncements, guides, and other guidance issued since the publication of last year's Alert.

Help Desk—For information on auditing and attestation standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org/members/div/auditstd/technic.htm. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team and available at www.aicpa.org.

SAS No. 97	<i>Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles</i>
SAS No. 98	<i>Omnibus Statement on Auditing Standards—2002</i>
SAS No. 99	<i>Consideration of Fraud in a Financial Statement Audit</i>
SAS No. 100	<i>Interim Financial Information</i>
SAS No. 101	<i>Auditing Fair Value Measurements and Disclosures</i>

(continued)

SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>
SSAE No. 12	<i>Amendment to Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification</i>
Audit and Accounting Guide	<i>Audits of State and Local Governments (GASB 34 Edition)</i>
Amendment to Interpretation No. 2 of SAS No. 31	"The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals"
Audit Interpretation No. 12 of SAS No. 1	"The Effect on the Auditor's Report of an Entity's Adoption of a New Accounting Standard That Does Not Require the Entity to Disclose the Effect of the Changes in the Year of Adoption"
Auditing Interpretation No. 15 of SAS No. 58	"Reporting as Successor Auditor When Prior-Period Audited Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations"
Auditing Interpretation No. 16 of SAS No. 58	"Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940"
Related-Party Toolkit	<i>Accounting and Auditing for Related Parties and Related Party Transactions: A Toolkit for Accountants and Auditors</i>
Practice Alert No. 02-2	<i>Use of Specialists</i>
Practice Alert No. 02-3	<i>Reauditing Financial Statements</i>
Practice Aid	<i>Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide</i>
Practice Aid	<i>New Standards, New Services: Implementing the Attestation Standards</i>
Practice Aid	<i>Assessing the Effect on a Firm's System of Quality Control Due to a Significant Increase in New Clients and/or Experienced Personnel</i>
Booklet	<i>Understanding Audits and the Auditor's Report: A Guide for Financial Statement Users</i>

The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 97, Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles

SAS No. 97, *Amendment to Statement on Auditing Standards No. 50, Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), revises SAS No. 50, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*, vol. 1, AU sec. 625), to prohibit an accountant from providing a written report on the application of accounting principles not involving facts and circumstances of a specific entity.

This Statement is effective for written reports issued or oral advice provided on or after June 30, 2002. Earlier application of the provisions of this Statement is permissible.

SAS No. 98, Omnibus Statement on Auditing Standards—2002

In September 2002, the ASB issued SAS No. 98, *Omnibus Statement on Auditing Standards—2002* (AICPA, *Professional Standards*, vol. 1), which makes various amendments to existing SASs, including SAS No. 95; SAS No. 25, *The Relationship of Generally Accepted Auditing Standards to Quality Control Standards* (AICPA, *Professional Standards*, vol. 1, AU sec. 161.02 and .03); SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312); SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324); SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.65); SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550); SAS No. 52, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU secs. 551 and 558); and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551).

SAS No. 101, Auditing Fair Value Measurements and Disclosures

This Statement establishes standards and provides guidance on auditing fair value measurements and disclosures contained in fi-

financial statements. In particular, the Statement addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. This Statement is effective for audits of financial statements for periods beginning on or after June 15, 2003, with earlier application permitted.

Accounting Developments

FASB Issues Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*

In April 2003, the FASB issued FASB Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*. The statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under FASB Statement No. 133. In particular, FASB Statement No. 149 amends FASB Statement No. 133 to say the following:

Certain investment contracts. A contract that is accounted for under either paragraph 4 of FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, or paragraph 12 of FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, as amended by Statement 110, is not subject to this Statement. Similarly, a contract that is accounted for under either paragraph 4 or paragraph 5 of AICPA Statement of Position 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, is not subject to this Statement. Those exceptions apply only to the party that accounts for the contract under Statement 35, Statement 110, or SOP 94-4.

FASB Statement No. 149 is effective for contracts entered into or modified after June 30, 2003, with certain exceptions as described in FASB Statement No. 149, and for hedging relationships designated after June 30, 2003. The guidance should be applied prospectively.

Since the issuance of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, questions were raised regarding the proper accounting for such contracts as insurance contracts, GICs, and synthetic GICs that are held by various defined contribution pension and health and welfare plans.

FASB Statement No. 110, *Reporting by Defined Benefit Pension Plans of Investment Contracts*, amends FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, to require defined benefit plans to report insurance contracts “in the same manner as specified in the annual report filed by the plan with certain governmental agencies pursuant to ERISA” (that is, at either fair value or contract value). SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Pension Plans*, indicates that a fully benefit-responsive investment contract should be reported at contract value and provides an example of a fully benefit-responsive synthetic GIC as an investment contract that is subject to SOP 94-4.

A conflict with FASB Statement No. 133 arose because for some insurance contracts with embedded derivatives, FASB Statement No. 133 required that the insurance contract be bifurcated and the embedded derivative be accounted for separately (that is, at fair value). In addition, FASB Statement No. 133 Implementation Issue No. A16, “Synthetic Guaranteed Investment Contracts,” concluded that synthetic GICs met FASB Statement No. 133’s definition of a *derivative instrument* from the perspective of the issuer. Since FASB Statement No. 133’s definition applied to the terms of the contract, that conclusion also implied that synthetic GICs met the definition of a derivative from the viewpoint of the holder. A conflict arose because FASB Statement No. 133 did not contain an exception for synthetic GICs held by reporting entities subject to SOP 94-4 until now.

Accounting Trends & Techniques—Employee Benefit Plans

Accounting Trends & Techniques—Employee Benefit Plans is a new publication intended to provide preparers and auditors of employee benefit plan financial statements with a compilation of illustrative financial statement disclosures and illustrative auditor’s reports

based on examples from actual financial statements of all types of audited employee benefit plans. In addition, the publication contains an entire chapter illustrating management letters and common management letter comments found on actual plan audits.

Help Desk—To order this publication, call the AICPA Member Satisfaction Center at (888) 777-7077 and ask for product no. 006611kk.

New Accounting Pronouncements and Other Guidance

Presented here is a list of accounting pronouncements and other guidance issued since the publication of last year's Alert.

Help Desk—For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org, and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

FASB Statement No. 145	<i>Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections</i>
FASB Statement No. 146	<i>Accounting for Costs Associated with Exit or Disposal Activities</i>
FASB Statement No. 147	<i>Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9</i>
FASB Statement No. 148	<i>Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123</i>
FASB Statement No. 149	<i>Amendment of Statement 133 on Derivative Instruments and Hedging Activities</i>
FASB Statement No. 150	<i>Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity</i>
FASB Interpretation No. 45	<i>Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others</i>
FASB Interpretation No. 46	<i>Consolidation of Variable Interest Entities</i>
SOP 01-5	<i>Amendment to Specific AICPA Pronouncements for Changes Related to the NAIC Codification</i>

SOP 01-6	<i>Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others</i>
SOP 02-2	<i>Accounting for Derivative Instruments and Hedging Activities by Not-for-Profit Health Care Organizations, and Clarification of the Performance Indicator</i>
Technical Practice Aids	<i>Software Revenue Recognition</i>
Questions & Answers	<i>FASB Statement No. 87, Employers' Accounting for Pensions</i>

For information on accounting standards issued subsequent to the writing of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org.

Audit and Accounting Guide Revisions as of March 1, 2003

The following list summarizes some of the revisions that will be included in the EBP Guide, with conforming changes as of March 1, 2003.

The EBP Guide has been updated to reflect the issuance of the following pronouncements:

- FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
- SAS No. 98, *Omnibus Statement on Auditing Standards—2002*
- SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*

The EBP Guide also provides guidance on confidentiality, indemnity, and business associates agreements, and includes a revised Appendix I to reflect the issuance of SAS No. 99.

Help Desk—To order the EBP Guide, call the Member Satisfaction Center at (888) 777-7077 or go to CPA2Biz.com and order product no. 012593kk.

AICPA Professional Ethics Division Interpretations and Rulings

Ethics Interpretations and rulings are promulgated by the executive committee of the Professional Ethics Division of the AICPA to provide guidelines on the scope and application of ethics rules but are not intended to limit such scope or application. Publication of an Interpretation or ethics ruling in the *Journal of Accountancy* constitutes notice to members. A member who departs from Interpretations or rulings shall have the burden of justifying such departure in any disciplinary hearing.

Help Desk—It is important for you to monitor the activities of the Professional Ethics Executive Committee because it may issue Interpretations, ethics rulings, or both, that may be relevant to your engagements. For full information about Interpretations and rulings, visit the Professional Ethics Team Web page at www.aicpa.org/members/div/ethics/index.htm. You can also call the Professional Ethics Team at (888) 777-7077, menu option 2, followed by menu option 2. It is important to point out that, for ERISA engagements, the DOL has separate independence standards that may be more restrictive than those of the AICPA. See paragraph A.85 in Appendix A of the EBP Guide for a listing of the DOL's independence standards.

This section of the Alert highlights some of the more important developments in the area of professional ethics and independence.

General Accounting Office Issues New Independence Rules

In January 2002 the Government Accounting Office (GAO) amended *Government Auditing Standards* (GAS, also referred to as the Yellow Book), significantly tightening its auditor independence provisions. In issuing the new standard, the comptroller general stated that protecting the public interest and ensuring public confidence in the independence of auditors of government financial statements, programs, and operations, both in form and substance, were the overriding considerations. The updated standard is required reading for auditors of government entities and of organizations receiving government funds.

Help Desk—To help members and others better understand the new standard, the AICPA has developed two educational tools, which are available on the Institute’s Web site (www.aicpa.org/members/div/ethics/index.htm): GAO independence standard and AICPA-GAO comparison of independence rules governing nonaudit services. In addition, the GAO issued a series of questions and answers relating to the standard (www.gao.gov/govaud/d02870g.pdf).

Recent Revisions to AICPA Ethics Interpretations and Rulings

In March and April 2003 the Professional Ethics Executive Committee (PEEC) revised the following rulings and Interpretations of the AICPA Code of Professional Conduct (see the March 2003 issue of the *Journal of Accountancy* for the revisions):

- Revision of Interpretation No. 101-1, “Interpretation of Rule 101,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Revision of Interpretation 101-2, “Former Practitioners and Firm Independence” (ET sec. 101.04)
- Revision of Interpretation No. 101-10, “The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements” (ET sec. 101.12)
- Revision of Ethics Ruling No. 41, “Financial Services Company Client Has Custody of a Member’s Assets,” of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.081-.082)
- Revision of Ethics Ruling No. 70, “Member’s Depository Relationship With Client Financial Institution” (ET sec. 191.140-.141)
- Deletion of Ethics Ruling No. 77, “Individual Considering or Accepting Employment With the Client” (ET sec. 191.154-.155)

In July 2002, the PEEC revised the following rulings and Interpretations of the AICPA Code of Professional Conduct; see the July 2002 issue of the *Journal of Accountancy* for the revisions:

- Interpretation No. 101-1, “Interpretation of Rule 101,” of ET sec. 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.02)
- Ethics Ruling No. 10, “Member as Legislator,” of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.019–.020)

In November 2002, the PEEC made certain revisions to the following ruling and Interpretation (see the November 2002 issue of the *Journal of Accountancy* for the revisions):

- Interpretation No. 101-5, “Loans From Financial Institution Clients and Related Terminology,” of ET section 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101.07)
- Ethics Ruling No. 107, “Participation in Health and Welfare Plan Sponsored by Client,” of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191.214–.215)

SEC Rules on Auditor Independence

The SEC has approved rules on auditor independence and audit working paper retention to implement provisions of the Sarbanes-Oxley Act of 2002. The new independence rules require certain disclosures and reports by auditors and set conditions under which auditing firms would not be considered independent for purposes of performing audits of public company financial statements. The new rules address issues such as:

- Revising the rules related to the nonaudit services that, if provided to an audit client, would impair an accounting firm’s independence
- Requiring that certain partners on the audit engagement team rotate after no more than five or seven consecutive

years, depending on the partner's involvement in the audit, except that certain small accounting firms may be exempt from this requirement

- Establishing rules that an accounting firm would not be independent if certain members of management of that issuer had been members of the accounting firm's audit engagement team within the one-year period preceding the commencement of audit procedures
- Establishing rules that an accountant would not be independent from an audit client if any "audit partner" received compensation based on the partner procuring engagements with that client for services other than audit, review, and attest services
- Requiring the auditor to report certain matters to the issuer's audit committee, including "critical" accounting policies used by the issuer
- Requiring the issuer's audit committee to preapprove all audit and nonaudit services provided to the issuer by the auditor
- Requiring disclosures to investors of information related to audit and nonaudit services provided by, and fees paid to, the auditor

For further information about these new rules, visit AICPA Online at www.aicpa.org/sarbanes/secproposesrules.asp.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented here is brief information about some ongoing projects that may be relevant to your engagements. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts, including downloading a copy of the exposure draft.

These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.com
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm

Help Desk—The AICPA’s standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate “exposure draft e-mail list” in the subject header field to help process your submission more efficiently. Include your full name, mailing address and, if available, your membership and subscriber number in the message.

Auditing Pipeline

Substantial Changes to Audit Process Proposed

In December 2002, the AICPA’s ASB issued an exposure draft proposing seven new SASs relating to the auditor’s risk assessment process. The ASB believes that the requirements and guidance provided in the proposed SASs, if adopted, would result in a substantial change in audit practice and in more effective audits.

The primary objective of the proposed SASs is to enhance auditors' application of the audit risk model in practice by requiring:

- More in-depth understanding of the entity and its environment, including its internal control, to identify the risks of material misstatement in the financial statements and what the entity is doing to mitigate them.
- More rigorous assessment of the risks of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

The exposure draft consists of the following proposed SASs:

- *Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards*
- *Audit Evidence*
- *Audit Risk and Materiality in Conducting an Audit*
- *Planning and Supervision*
- *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- *Amendment to Statement on Auditing Standards No. 39, Audit Sampling*

The proposed SASs establish standards and provide guidance concerning the auditor's assessment of the risks of material misstatement in a financial statement audit, and the design and performance of audit procedures whose nature, timing, and extent are responsive to the assessed risks. Additionally, the proposed SASs establish standards and provide guidance on planning and supervision, the nature of audit evidence, and evaluating whether the audit evidence obtained affords a reasonable basis for an opinion regarding the financial statements under audit.

The proposed SASs would be effective for audits of financial statements for periods beginning on or after December 15, 2004, to allow time for auditors to revise their methodologies and train their personnel to plan the initial application of these standards to their audits.

Accounting Pipeline

Exposure Draft on Loans and Certain Debt Securities Acquired in a Transfer (formerly known as Purchased Loans and Securities)

AcSEC is issuing an exposure draft of a proposed SOP titled *Accounting for Loans and Certain Debt Securities Acquired in a Transfer*. This proposed SOP considers whether Practice Bulletin (PB) No. 6, *Amortization of Discounts on Certain Acquired Loans*, continues to be relevant given a number of FASB pronouncements issued subsequent to PB No. 6. The proposed SOP excludes originated loans from its scope. Readers should be alert to any final pronouncement.

Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment

Proposed AICPA SOP *Accounting for Certain Costs and Activities Related to Property, Plant, and Equipment*, and proposed FASB Statement *Accounting in Interim and Annual Financial Statements for Certain Costs and Activities Related to Property, Plant, and Equipment—an amendment of APB Opinions No. 20 and 28 and FASB Statements No. 51 and 67 and a rescission of FASB Statement No. 73* were issued simultaneously for public comment. Principally, the proposed FASB Statement would amend FASB Statement No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*, to exclude from its scope the accounting for acquisition, development, and construction costs of real estate developed and used by an entity for subsequent rental activities. The accounting for those costs would be subject to the guidance in the proposed SOP. It also would amend APB Opinion No. 28, *Interim Financial Reporting*, to require that those costs that the proposed SOP would require be expensed as incurred on an annual basis also be expensed as incurred in interim periods.

The proposed SOP addresses accounting and disclosure issues related to determining which costs related to property, plant, and equipment should be capitalized as improvements and which should be charged to expense. The proposed SOP also addresses capitalization of indirect and overhead costs and component accounting for property, plant, and equipment. Final Statements are expected to be issued in 2003.

Exposure Draft—*Omnibus Proposal of Professional Ethics Division Interpretations and Rulings*

The PEEC proposes revisions to Rule 101, *Independence*, for nonattest services, loans, and leases. One of the PEEC's primary responsibilities is to interpret the AICPA *Code of Professional Conduct* and amend it when necessary to ensure its continued effectiveness in protecting the public interest by promoting AICPA members' independence, integrity, and objectivity. In accordance with that responsibility, an exposure draft has been issued to solicit feedback on proposed independence rule revisions. For more information on this exposure draft, visit the Professional Ethics section of the AICPA Web site (www.aicpa.org).

International Accounting Standards

The International Accounting Standards Committee (IASC) was formed in 1973 and is an independent, private sector body. The objective of the IASC is to harmonize the accounting principles for financial reporting around the world. The IASC publishes the International Accounting Standards.

Employee Benefit Plan-Related Standards

The following are employee benefit plan-related standards:

- International Accounting Standard (IAS) No. 19, *Employee Benefits*, addresses postemployment benefits including pensions.
- IAS No. 26, *Accounting and Reporting by Retirement Benefit Plans*, addresses the accounting and reporting by retirement benefit plans. It establishes separate standards for reporting by defined benefit plans and by defined contribution plans.

In June 2002 the IASB agreed to add a limited convergence project on postemployment benefits to its agenda. The purpose of this project is to build on the principles that are common to most existing national standards on postemployment benefits and to seek improvements to IAS No. 19 in certain specific areas.

Help Desk—For further information regarding the IASC and its standards visit its Web site at www.iasc.org.uk.

Resource Central

Employee benefit plan-related educational courses, Web sites, publications, and other resources available to CPAs

Related Publications

The following are some of the AICPA publications that deliver valuable guidance and practical assistance as potent tools to be used on your employee benefit plan engagements.

- AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of March 1, 2003 (product no. 012593kk).
- *New! Accounting Trends & Techniques—Employee Benefit Plans* (product no. 006611kk). Offering the same kind of powerful help that the AICPA's *Accounting Trends and Techniques* does, this comprehensive book illustrates a wide range of employee benefit plan financial statement disclosures and auditors' reports for both full-scope and limited-scope audits. The publication also includes a chapter dedicated to illustrative management letters and management letter comments.
- AICPA Practice Aid *Auditing Multiemployer Plans* (product no. 006603kk). This publication provides guidance on unique issues regarding the accounting, auditing, and reporting on financial statements of various types of multi-employer employee benefit plans. This nonauthoritative Practice Aid is designed to complement the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

There are chapters on SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans*; application; investments; employer payroll audits; internal control testing; and more. Also included are illustrative financial statements for various types of multiemployer employee benefit plans.

- Checklists and Illustrative Financial Statements for:
 - *Defined Benefit Pension Plans* (008776kk). The 2003 checklist will be available this summer (product no. 008789kk).
 - *Defined Contribution Pension Plans* (008777kk). The 2003 checklist will be available this summer (product no. 008790kk).
 - *Health and Welfare Benefit Plans* (008778kk). The 2003 checklist will be available this summer (product no. 008791kk).
- “A Wake-Up Call,” an employee benefit plan audit video (013801kk).

AICPA's reSOURCE Online Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, Technical Practice Aids, Audit and Accounting Guides (all 23), Audit Risk Alerts (all 19), and *Accounting Trends & Techniques*. To subscribe to this essential service, go to CPA2biz.com.

reSOURCE CD-ROM

The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature*. This CD-ROM enables subscription access in Windows format to AICPA Professional Literature products, namely, *Professional Standards*, *Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set that includes all Guides and the related Audit Risk Alerts, or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

Conferences

National Conference on Employee Benefit Plans

Each spring the AICPA sponsors a National Conference on Employee Benefit Plans that is specifically designed to update auditors, plan administrators, and industry or plan sponsors on various topics, including recent and proposed employee benefit plan legislative and regulatory issues, and significant accounting, auditing, and tax developments. The 2004 National Conference on Employee Benefit Plans will be held May 3–5, 2004, in Orlando, Florida. For a conference brochure, please call (888) 777-7077, and request brochure G50038; for more information, visit the Web site at www.cpa2biz.com/conferences.

Education Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working on employee benefit plan engagements. Those courses include:

- *Audits of Employee Benefit Plans*
- *Audits of 401(k) Plans*

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, *AICPA InfoBytes* now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 (\$369 nonmembers) for a new subscription and \$119 (\$319 nonmembers) for the annual renewal. Divided into one- to two-credit courses that are available 24/7, *AICPA InfoBytes* offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit <http://cpa2biz.com>.

CPE CD-ROM

The Practitioner's Update (product no. 738110kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pro-

nouncements that will become effective during the upcoming audit cycle.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, CPA2Biz.com offers all the latest AICPA products, including Audit Risk Alerts, Audit and Accounting Guides, *Professional Standards*, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the table at the end of this Alert.

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This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments-2002*.

The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit and industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be greatly appreciated. You may e-mail these comments to ldelahanty@aicpa.org or write to:

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Jersey City, NJ 07311-3881

APPENDIX A

IRS Limits on Benefits and Compensation

	<i>2003</i>	<i>2002</i>	<i>2001</i>
Defined benefit			
Maximum annual pension	\$160,000	\$160,000	\$140,000
Defined contribution			
Maximum annual addition	\$40,000	\$40,000 ¹	\$35,000
401(k) plan			
Maximum elective deferral	\$12,000	\$11,000 ²	\$10,500
403(b) plan			
Maximum elective deferral	\$12,000	\$11,000	\$10,500
457 plans	\$12,000	\$11,000	\$8,500
SIMPLE plans	\$8,000	\$7,000	\$6,500
Qualified plans			
Maximum compensation limits	\$200,000	\$200,000	\$170,000
Highly compensated limits	\$90,000	\$90,000	\$85,000
Officer limits (key employee)	\$130,000	\$130,000	\$70,000
FICA taxable wage base	\$87,000	\$84,900	\$80,400
Employer and employee Social Security tax	6.20%	6.20%	6.20%

1. The limitation for defined contribution plans is increased from \$35,000 to \$40,000 effective for limitation years beginning after December 31, 2001, and remained at \$40,000 for 2003.
2. See Appendix C for a summary of major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001. These changes include catch-up contributions for individuals over age 50. The catch-up contribution increased from \$1,000 in 2002 to \$2,000 in 2003.

APPENDIX B

Commonly Asked Questions and Answers

The following questions and answers have been developed by the members of the 2002 Employee Benefit Plans Audit Guide Revision Task Force. They include frequently asked questions encountered by the task force members on accounting, auditing, and regulatory matters.

- Q.** Can the plan sponsor accept a certification from the plan's recordkeeper if the recordkeeper certifies the investment information to be complete and accurate on behalf of the plan's trustee/custodian as "agent for"?
- A.** According to the U.S. Department of Labor (DOL), such a certification generally would be acceptable if there is in fact a legal arrangement between the trustee and the recordkeeper to be able to provide the certification on the trustee's behalf. Care should be taken by the plan administrator to obtain such legal documentation. Additionally the plan auditor might consider adding wording to the standard limited scope report to include reference to such an arrangement. Sample language might include the following: "any auditing procedures with respect to the information described in Note X, which was certified by ABC, Inc., the recordkeeper of the Plan as agent for XYZ Bank, the trustee of the Plan, . . . We have been informed by the plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the agent on behalf of the trustee, as of and for the year ended December 31, 20XX, that the information provided to the plan administrator by the agent for the trustee is complete and accurate." The third paragraph of the report should also be modified.
- Q.** Is it permissible to perform a limited scope audit on a portion of the plan's investments but not all (some investments did

not meet the DOL 29 CFR 2520.103-8 criteria for a limited scope audit)? If yes, what form does the auditors' report take?

A. Yes, it is permissible to perform a limited scope audit on only a portion of a plan's investments and audit the remaining investments. The auditors' report is the same as that used for a limited scope audit. However, the note that is referenced in the auditor report should clearly identify the investments that were not audited.

Q. Under Form 5500 (Schedule H, Part IV, line 4j), there is a special rule whereby transactions under an individual account plan that a participant directs should not be taken into account for purposes of preparing the Schedule of Reportable Transactions. What about situations where an individual account plan is participant-directed but has certain transactions that appear to be nonparticipant-directed (for example, "pass through" account for contributions)?

A. If the plan is an individual account plan and the overall structure of the plan is participant-directed, "pass through" account transactions would not be required to be included on the Schedule of Reportable Transactions. Another example would be a participant-directed individual account plan that liquidates its investment options as a result of a plan termination, merger, or change in service provider. Often such changes result in the plan sponsor directing the plan trustee to liquidate the current balance in the participant-directed investment options into a short-term fund before the transfer to new investment options. Such transactions would be not be required to be included on the Schedule of Reportable Transactions.

Q. What are the general conditions requiring an audit of pension plan financial statements?

A. An audit generally is required if the plan is covered under Title I of the Employee Retirement Income Security Act of 1974 (ERISA) and there are over 100 participants as of the beginning of the plan year. Exhibit 5-2 in Chapter 5 of the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of March 1, 2003

(the EBP Guide) provides guidance on determining who is considered a participant. In addition, DOL regulations permit plans that have between 80 and 120 participants at the beginning of the plan year to complete the Form 5500 in the same category (“large plan” or “small plan”) as was filed in the previous year.

- Q.** What audit procedures should be performed on material plan mergers into a plan? What audit procedures are required when the prior plan was audited? What if the prior plan was never audited?
- A.** If the prior plan was audited, the auditor should obtain the audited financial statements to ensure that the balance transferred from the prior plan financial statements reconciles to the balance that is reflected on the new plan’s financial statements. Also, the auditor will generally perform procedures to ensure that a sample of participant accounts were properly set up under the new plan. In addition to the participant level testing, if the prior plan was not audited, the auditor will generally perform audit procedures to determine that the equity that is transferred from the prior plan is reasonable based upon an analysis of historical activity. (Other audit procedures relating to plan mergers can be found in paragraphs 12.13 through 12.16 of the EBP Guide.)
- Q.** When a plan operates in a decentralized environment, what additional audit procedures should be considered?
- A.** The auditor should consider the controls at each decentralized location as well as the overall mitigating controls that may be performed on a centralized basis. Taking into consideration the materiality of the activity at each decentralized location, the auditor may choose to expand participant level and substantive testing to incorporate these decentralized locations.
- Q.** When the majority of a plan’s assets are held in a master trust, but the plan has investments outside of the master trust, what are the requirements for the supplemental schedules?
- A.** The Form 5500 instructions exclude master trust assets from the supplemental schedule reporting requirements.

However, any assets held outside the master trust must be reported on the supplemental schedules. When calculating the 5 percent threshold for disclosing reportable transactions, the current value of master trust assets is subtracted from the beginning of the year net asset balance.

- Q.** Is the master trust required to be audited?
- A.** While the DOL does not require the master trust to be audited, the plan administrator normally engages an auditor to report only on the financial statements of the individual plans. If the master trust is not audited, the plan auditor should perform those procedures necessary to obtain sufficient audit evidence to support the financial statement assertions as to the plan's investments or qualify or disclaim his or her report.
- Q.** Is a certification at the master trust level acceptable under DOL regulation 2520.103-8?
- A.** If a limited scope audit is to be performed on a plan funded under a master trust arrangement or other similar vehicle, the DOL requires separate individual plan certifications from the trustee or the custodian regarding the allocation of the assets and the related income activity to the specific plan.
- Q.** Should noninterest-bearing cash be included as an asset on the supplemental schedule of assets (held at end of year)?
- A.** Generally, only assets held for investment are included on the supplemental schedule of assets (held at end of year); thus noninterest-bearing cash would not be included. Interest-bearing cash accounts would be included on the supplemental schedule.
- Q.** Can immaterial investments be netted together as "other" on the supplemental schedule of assets (held at end of year)?
- A.** No, each investment must be separately listed on the supplemental schedule.
- Q.** What is the auditor's responsibility for detecting nonexempt transactions resulting from participant contributions that are not remitted to the plan within the guidelines established by DOL regulations?

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- A. An audit performed in accordance with generally accepted auditing standards (GAAS) cannot be expected to provide assurance that all party-in-interest transactions will be discovered. Nevertheless, during the audit the auditor should be aware of the possible existence of party-in-interest transactions. During the planning phase of the audit, the auditor should inquire about the existence of any party-in-interest or nonexempt transactions. If any issues relating to late remittances are brought to the auditor's attention, the auditor may consider obtaining a schedule of employee contributions detailing payroll withholding date and date of deposit to the plan. A sample of deposits can then be traced to the supporting payroll register and wire transfer advice or check. Further, the auditor should have the client include in the management representation letter a representation that there are no party-in-interest transactions that have not been disclosed in the supplemental schedules.
- Q. If a nonexempt transaction related to the above is noted, is materiality of the transaction taken into consideration in determining the need for the supplemental schedule of nonexempt transactions?
- A. There is no materiality threshold for the inclusion on the supplemental schedule. All known events must be reported.
- Q. When is a plan subject to the requirements of the Securities and Exchange Act of 1933, thus requiring a Form 11-K filing under the Securities and Exchange Act of 1934?
- A. Section 3(a)(2) of the Securities and Exchange Act of 1933 provides exemptions from registration requirements for defined benefit plans and defined contribution plans not involving the purchase of employer securities with employee contributions. All other plans are subject to the requirements, provided they are both voluntary and contributory. (For further guidance, see paragraph 12.24 of the EBP Guide.) Advice of counsel should be obtained to determine if the registration requirements apply to the plan.
- Q. In a defined contribution plan, can investments be shown as a one-line item on the financial statements?

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- A. Participant-directed plan investments may be shown in the aggregate, as a one-line item in the statement of net assets available for benefits. The presentation of nonparticipant-directed investments in the statement of net assets available for benefits or in the notes should be detailed by general type, such as registered investments companies, government securities, corporate bonds, common stocks, and so on.
- Q. If investments are shown as a one-line item in a defined contribution plan, what disclosures are required?
- A. The presentation should indicate whether the fair values of the investments have been measured by quoted market prices in an active market or were determined otherwise. Investments that represent 5 percent or more of the net assets available for benefits should be separately identified. If any of those investments are nonparticipant-directed, they should be identified as such. Listing all investments in the schedule of assets (held at end of year) required by the ERISA does not eliminate the requirement to include this disclosure in the financial statements.
- Q. Are participant loans considered an investment on the face of the financial statements or as a loan receivable?
- A. Loans are considered an investment for reporting purposes.
- Q. Should the benefits paid per the statement of changes in net assets available for plan benefits agree to the benefits paid in the statement of changes in accumulated plan benefits for a defined benefit pension plan?
- A. The benefits paid should be the same on both statements. If differences are noted, the auditor should resolve the issue with the actuary to determine if the actuarial number requires adjustment.
- Q. Is the schedule of 5 percent reportable transactions required for defined benefit plans?
- A. As defined benefit plans generally are not participant-directed, the reportable transactions schedule would be required.
- Q. When does a health and welfare plan require an audit?

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- A. A health and welfare plan is required to have an audit when the plan has more than 100 participants at the beginning of the plan year (this can be expanded to 120 if the 80-to-120-participant rule applies) and the plan is funded. According to DOL Regulation 2520.104-44, the existence of a separate fund or account for the plan by the employer or a third-party administrator (TPA) can cause the requirement that funds be paid directly from the general assets of the sponsor not to be met. For example, if a separate account is maintained that would be deemed to be a trust under state law, the related plan would be deemed to be funded under ERISA. It is not always easy to determine when a plan is considered funded. The auditor may wish to consult with legal counsel, plan actuaries, or the DOL to determine if a plan meets the definition of funded.
- Q. Are participants counted the same way for pension plans and health and welfare benefit plans?
- A. Participants for health and welfare plans are employees who are eligible and are receiving coverage under the plan.
- Q. If participants are contributing toward the health and welfare benefits, is an audit required?
- A. According to DOL Technical Releases 88-1 and 92-1, participant contributions to a welfare plan that has an Internal Revenue Code (IRC) section 125 cafeteria plan feature do not have to be held in trust. If contributions are not through a Section 125 plan and they are not used for the payment of insurance or health maintenance organization (HMO) premiums, generally, they will be required to be held in trust. If the plan is funded voluntarily or as required by DOL regulation, then the plan would require an audit.
- Q. If a plan offers several benefits under the plan document, and only medical is funded through the voluntary employees' beneficiary association (VEBA) trust, what is the audit requirement?
- A. The audit requirement is of the plan; not the trust. All benefits covered by the plan should be included in the audited financial statements.

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- Q. If a VEBA trust is used as a pass-through for claims payment during the year, but there are no monies in the VEBA trust at year end, is an audit of the plan required?
- A. If a plan is deemed to be funded for a part of a plan year, the entire plan year is subject to the audit requirement. All plan activity for the entire year would have to be included in the audited financial statements.
- Q. If multiple plans use a VEBA trust, can an audit be performed at the VEBA trust level?
- A. The audit requirement is of the plan, not the trust. Each plan would require a separate audit if it individually met the audit requirement (see previous question). The auditor may be engaged to audit the VEBA trust in order to assist with the plan level allocation reporting, but this would not fulfill the plan level audit requirement.
- Q. Does the funding of a health and welfare benefit plan through a 401(h) account, when the plan was otherwise unfunded, cause the plan to require an audit?
- A. If the plan was otherwise unfunded, the 401(h) account association will not cause the health and welfare benefit plan to be considered funded for audit determination purposes.
- Q. What responsibility does the auditor have in testing plan qualification tests (for example, ACP and ADP) prepared by a client's third-party administrator?
- A. An audit in accordance with GAAS is not designed to ensure compliance with all legislative and regulatory provisions. However, Plans must be designed and comply with certain operating tests in order to maintain their qualified status. If specific information comes to the auditor's attention that provides evidence concerning the existence of possible violations affecting the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether a violation has occurred. The auditor is also expected to inquire of, and obtain representation from, management concerning compliance with laws and regulations and the prevention of violations that may cause disqualification.

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- Q. If the plan fails its 2000 discrimination test and has to return employee contributions in 2001 should "Excess Contribution Payable" liability be shown on the 2000 financial statement?
- A. Yes, the financial statements should reflect a liability for excess contributions payable on the financial statements if the amount is material to the financial statements.
- Q. What alternate audit procedures should be done to test participants' investment allocation of deferral contributions where no documentation exists (participants can change deferrals and allocation of such online or via phone)?
- A. Where participants make contributions or investment elections by telephone or electronic means (such as the Internet), consider confirming contribution percentage, source, and investment election directly with the participant or compare to a transaction report, if one is maintained. Alternatively, if the service provider has a Type II Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended, report that provides evidence that the service auditor has tested investment allocations, the auditor may place some reliance on the SAS No. 70 report to reduce other testing.
- Q. For a DOL-limited scope audit, is it necessary to test the allocation of investment earnings at the participant account level?
- A. The testing of allocation of investment earnings at the participant level is part of the participant data testing and is required for a limited scope audit.
- Q. How should a late transmittal be handled in a multiemployer 401(k) plan audit where one of the participating employers submitted its cumulative contribution report containing late employee 401(k) contributions? What needs to be disclosed on the financial statement and Form 5500?
- A. The lost earnings due to the plan because of the late contribution should be shown on Form 5500 Schedule G, "Schedule of Nonexempt Transactions." The board of trustees should be made aware of the fact that there is a pro-

hibited transaction that is required to be reported on the supplemental schedule of nonexempt transactions, which is part of the audited financial statements. The employer is responsible for depositing the lost earnings into the plan, filing the excise tax return, and paying the excise tax.

Q. I understand that brokerage accounts can be listed on one line item on the Form 5500. Can they be listed on one line item on the supplemental schedules to the financial statements or do the individual underlying investments have to be listed?

A. Individually directed brokerage accounts may be listed as one line item on the statement of net assets available for benefits and on the supplemental schedule of assets, provided the investments are not loans, partnerships or joint-venture interests, real property, employer securities, or investments that could result in a loss in excess of the account balance of the participant or beneficiary who directed the transaction. However, the notes to the financial statements must disclose any individual investment that is over 5 percent of net assets available for benefits at the end of the year. In addition, the investment income for individually directed brokerage accounts may be shown as one line item in the Form 5500; however, the financial statements must separate interest and dividends from net appreciation (depreciation) in fair value on the statement of changes in net assets available for benefits and disclose net appreciation (depreciation) by type of investment in the notes to the financial statements.

APPENDIX C

Summary of Major Retirement Plan Law Changes

The following table summarizes the major retirement plan law changes resulting from the Economic Growth and Tax Relief Reconciliation Act of 2001.

Summary of Major Retirement Plan Law Changes

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
1	Increased IRA contribution limits IRC § 219	The current \$2,000 contribution limit is increased for traditional and Roth IRAs to \$3,000 beginning in 2002, then to \$4,000 in 2005, and \$5,000 in 2008. After 2008, the limit will be adjusted for inflation.	2002	601
2	Catch-up IRA contributions for individuals over 50 IRC § 219	Individuals who are at least age 50 by the end of the tax year can increase their normal IRA contribution limit by \$500 per year for 2002–2005 and \$1,000 for 2006 and later. Thus, for example, such an individual's total limit in 2002 will be \$3,500 (\$3,000 regular limit plus the special over 50 limit of \$500).	2002	601
3	Increased benefit and contribution limits for qualified plans IRC §§ 401(a)(17) and 415	<p>New law limits:</p> <ul style="list-style-type: none"> • Section 415(b)(1)(A) limit on annual benefits from a defined benefit plan will be \$160,000. • Section 415(c)(1) limit on annual additions to a defined contribution plan is raised from \$35,000 to \$40,000. • Section 401(a)(17) limit on compensation for plan purposes is raised from the current \$170,000 to \$200,000. <p>All three new limits will be indexed for inflation after July 1, 2001.</p>	<ul style="list-style-type: none"> • Years ending after 2001 • Years beginning after 2001 • Years beginning after 2001 	611

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
4	Elective deferrals IRC § 402(g)	The current \$10,500 limit on elective deferrals is increased to \$11,000 in 2002 and then by \$1,000 each year until it reaches \$15,000 in 2006.	2002	611
5	Elective deferrals to SIMPLE plans IRC § 408(p)(2)	The current \$6,500 SIMPLE retirement account limit is increased to \$7,000 in 2002 and then by \$1,000 each year until it reaches \$10,000 in 2005.	2002	611
6	Plan loans for owner employees IRC § 4975(f)(6)	<p>The special restrictions under current law on plan loans to owner employees is generally eliminated. This will allow for loans to sole proprietors, more-than-10% partners, and more-than-5% sub-S shareholders under the same rules as for other employees.</p> <p>Present law restrictions will continue to prohibit loans from IRAs, including SEPs and SIMPLE IRAs.</p>	2002	612
7	Top-heavy provisions IRC § 416(i)	<p>The top-heavy rules are changed: Three changes have been made to the definition of <i>key employee</i>: (1) The determination will be based solely on the participant's status and compensation in the plan year containing the determination date (the preceding 4 years will no longer be considered), (2) an officer is treated as a key employee based on officer status only if the employee earns more than \$130,000, and (3) the "top 10 owner" category has been eliminated.</p> <p>Matching contributions will now count toward satisfying the top-heavy minimums.</p> <p>The matching contribution of a safe harbor 401(k) plan will be deemed to satisfy the top-heavy rules. This does not mean that the match will automatically satisfy top-heavy rules for an accompanying profit-sharing plan, although the matching contributions will count toward otherwise satisfying the minimum.</p>	2002	613

(continued)

Summary of Major Retirement Plan Law Changes (cont'd)

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		The 5-year look-back rule applicable to distributions will be shortened to one year for distributions other than in-service distributions.		
		A frozen top-heavy defined benefit plan will no longer be required to make minimum accruals on behalf of non-key employees.		
8	Elective deferrals and employer deduction limits IRC § 404(n)	Elective deferrals will no longer be considered employer contributions for purposes of the IRC § 404 deduction limits.	2002	614
9	Deduction limit definition of compensation IRC § 404(a)(3)(A)	The definition of compensation for purpose of the deduction limit rules will include salary reduction amounts treated as compensation under IRC § 415 (e.g., 401(k) plan elective deferrals).	2002	616
10	Profit-sharing and stock bonus plan deduction limit increased IRC § 404(a)	The annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15% to 25% of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purpose of the deduction rules.	2002	616
11	Option to treat elective deferrals as Roth contributions IRC § 402A	Effective for tax years beginning after 2005, the Act allows participants in certain plans to make after tax deferrals treated as Roth contributions.	Effective for years beginning after 2005	617
12	Tax credit for contributions IRC § 25B	From 2002 through 2006, eligible taxpayers will receive a nonrefundable tax credit of up to 50% of contributions made to an IRA, 401(k), 403(b), SIMPLE, SEP, or 457 plan. This credit is available on the first \$2,000 of	2002	618

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
		<p>contributions (reduced by certain distributions) and is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution.</p> <p>The amount of the credit is determined by the adjusted gross income (AGI). For a joint filer with an AGI between \$0–\$30,000, the credit rate is 50%. The rate decreases to 20% when the AGI exceeds \$30,000 and then to 10% when the AGI exceeds \$32,500; it finally phases out at AGI of \$50,000.</p>		
13	Credit for new retirement plan expenses IRC § 45E	<p>Effective for plans established after December 31, 2001, in tax years beginning after that date, the Act provides a nonrefundable income tax credit for the administrative and retirement-education expenses of a small business that adopts a new qualified defined benefit or defined contribution plan, a SIMPLE plan, or SEP. The credit applies to 50% of the first \$1,000 of qualified expenses for each of the first three years of the plan.</p> <p>The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. For an employer to be eligible for the credit, the plan must cover at least one non-highly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees who have been with the employer at least three months. The 50% of qualifying expenses offset by the credit are not deductible. However, the other 50% of such expenses (along with other expenses above the \$1,000 limit) are deductible to the extent permitted under present law.</p>	2002	619

(continued)

Summary of Major Retirement Plan Law Changes (cont'd)

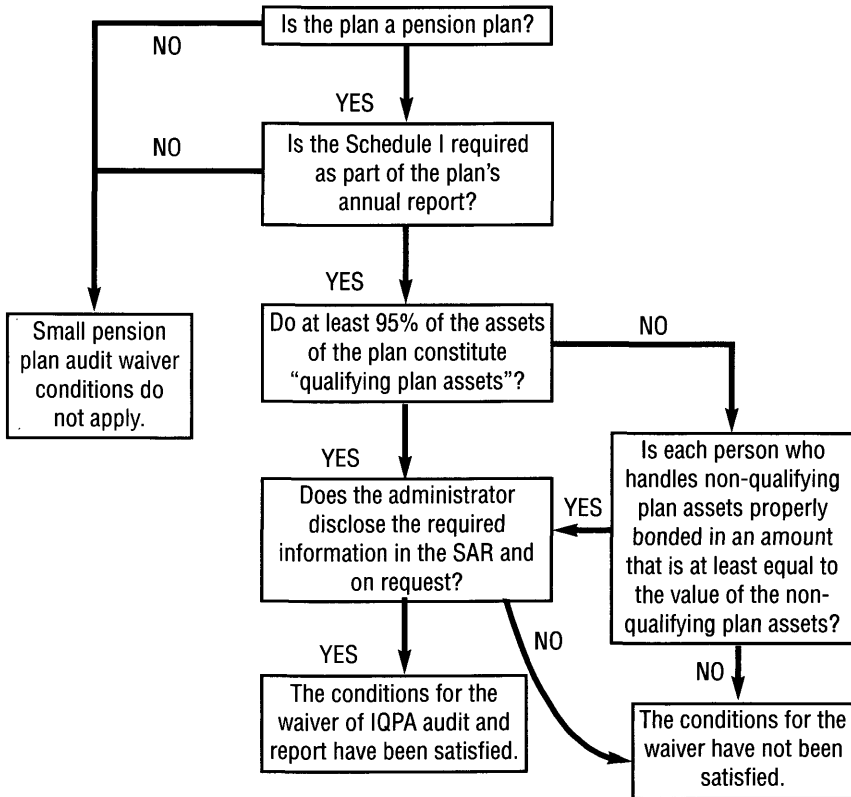
<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
14	Catch-up contributions IRC § 414(v)	<p>A plan may allow individuals who have attained age 50 by year end to make catch-up contributions. The otherwise applicable dollar limit on elective deferrals under a Section 401(k) or Section 457 plan, Section 403(b) annuity, SEP, or SIMPLE is increased. Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, they are not subject to applicable nondiscrimination rules. However, they must be available to all participants over age 50 on an equal basis.</p> <p>An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.</p> <p>The allowable catch-up contribution applicable to 401(k), 403(b), SEP, and 457 for 2002 is \$1,000. This amount is increased by \$1,000 each year until it reaches \$5,000 in 2006.</p> <p>For SIMPLE IRA and 401(k) plans, the amount for 2002 is \$500 and is increased \$500 each year until it reaches \$2,500 in 2006.</p>	2002	631
15	Increased annual additions limit for defined contribution plans IRC § 415(c)(1)	The annual additions limit is increased from 25% of compensation under a defined contribution plan to 100% of compensation.	2002	632
16	Rollovers among various types of plans IRC §§ 402, 403, 408, 457, and 3401	Generally distributions from a qualified retirement plan. Section 403(b) annuity, IRA, or Section 457 plan can be rolled over to any of such plans or arrangements.	2002	641-643

<i>No.</i>	<i>Description</i>	<i>New Law</i>	<i>Effective</i>	<i>Act Section</i>
17	Vesting IRC § 411(a)	Employer matching contributions must vest under a maximum 3-year cliff or 6-year graded vesting schedule.	Generally effective for plan years beginning after 2001	633
18	Waiver of 60-day rollover rule	The IRS may waive the 60-day rollover period if the failure to provide a waiver would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual.	2002	644
19	Employer-provided retirement advice IRC § 132	Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludible from income and wages. The benefit must be available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.	2002	665
20	Deemed IRAs under employer plans IRC § 408	A qualified employer plan may elect to allow employees to make traditional or Roth IRA-type contributions to the plan.	Years beginning after December 31, 2002	602
21	Elimination of user fee for determination letter requests for small employers	User fees will be eliminated for determination letters requested by small employers within 5 years of the adoption of a new plan or within 5 years of the end of a remedial amendment period beginning in the first 5 years the plan is in existence.	2002	620
22	Multiple-use test IRC § 401(m)	The multiple use of the alternative limit test has been repealed. Employers may use the alternative limit to pass both the ADP and the ACP tests.	2002 2002	666 666

APPENDIX D

Small Pension Plan Audit Waiver Summary

Small Pension Plan Audit Waiver Summary
(Applies to Plan Years Beginning on or After April 18, 2001)



APPENDIX E

Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting and Misappropriation of Assets

This appendix contains examples of risk factors presented separately relating to the two types of fraud relevant to the auditor's consideration—that is, fraudulent financial reporting and misappropriation of assets. Risk factors are further classified based on the three conditions generally present when fraud exists:

1. *Incentive/pressure* to perpetrate fraud
2. *Opportunity* to carry out the fraud
3. *Attitude/rationalization* to justify the fraudulent action

Although the risk factors cover a broad range of situations, they are only examples and, accordingly, the engagement team may wish to consider additional or different risk factors. Not all of these examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size or with different ownership characteristics or circumstances. Also, the order of the examples of risk factors provided is not intended to reflect their relative importance or frequency of occurrence.

I. RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM FRAUDULENT FINANCIAL REPORTING

Incentives/Pressures

Financial stability or profitability of the plan is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):

- Financial stability or profitability of the plan sponsor is threatened by economic, industry, or entity operating conditions

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- The plan holds employer securities and the employer is in an industry in which the value of the securities is subject to significant volatility or is not readily determinable
 - The plan has limited investment options or has invested significantly in employer assets other than employer securities
 - Poor investment results, especially compared to that of other similar plans
 - Recurring negative cash flows combined with an underfunded position
 - New accounting, statutory, or regulatory requirements, such as legislation that increases benefits of public employee retirement plans (PERs) or the Health Insurance Portability and Accountability Act of 1996 (HIPAA) for health care plans that process their own claims

Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:

- Public relations risk of large investment that becomes worthless, especially if a derivative or nonregulated investment such as a hedge fund or “alternative investments”
- Investment return expectations of participants, participating employers, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management
- Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as plan sponsor business combinations or multiemployer plan attempts to attract new employers or to prevent departure of current employers

Opportunities

The nature of the industry or the plan’s operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:

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- Senior management of the plan sponsor appointing itself trustee of the plan and having the opportunity in that position to benefit the plan sponsor (for example, to use the plan's money for speculative investing or to support the plan sponsor through purchasing employer assets or supporting a supplier)
 - Significant related-party transactions not in the ordinary course of business or with related plans not audited or audited by another firm
 - Non-readily marketable investments where valuation is based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate, such as unregulated investments (hedge funds or "alternative investments") or real estate
 - In-kind contributions from the plan sponsor

There is ineffective monitoring of management as a result of the following:

- Lack of oversight by plan management of outside service providers such as investment custodians, investment managers, recordkeepers, claims administrators, or paying agents
- Domination of plan management by a single person or small group without compensating controls
- Ineffective board of directors or committee oversight over the financial reporting process and internal controls
- Lack of competence of plan trustees because of background and lack of training

There is a complex or unstable organizational structure as evidenced by the following:

- Difficulty in determining the committee or individuals that have oversight or fiduciary responsibility for the plan
- Turnover of plan management, oversight committee members, counsel, board members, or outside service providers

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls
- High turnover rates or employment of ineffective accounting, internal audit, or information technology staff
- Ineffective accounting and information systems including situations involving reportable conditions

Attitudes/Rationalizations

We may not be able to observe risk factors reflective of attitudes/rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting. Nevertheless, if we become aware of the existence of such information, we should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting.

The following matters have come to our attention:

- Ineffective communication, implementation, support, or enforcement of the plan sponsor or plan's values or ethical standards by management or the communication of inappropriate values or ethical standards
- Lack of management candor in dealing with plan participants, claimants, outside service organizations, actuaries, and auditors regarding decisions that could have an impact on plan assets, including restructuring or downsizing arrangements
- Failure by management to have adequate valuations performed, including actuarial valuations
- The plan administrator lacks an understanding of the major regulations that govern the plans (for example, Employee Retirement Income Security Act (ERISA), HIPAA, the Internal Revenue Code (IRC), and State legislation)
- Management displays a significant disregard toward compliance with laws and regulations, such as ERISA, HIPAA, IRC, and Department of Labor (DOL)

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- The plan administrator custodian or trustees have been investigated by the DOL, Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC), or other party
 - The plan has participated in a voluntary compliance program in conjunction with the IRS or DOL. Such participation a possible indication of ineffective management of the plan or controls over the plan
 - Management failing to correct known operational deficiencies, prohibited transactions, or reportable conditions on a timely basis

The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:

- Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters
- Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report
- Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or oversight committee
- Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement

II. RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM MISAPPROPRIATION OF ASSETS

Some of the risk factors related to misstatements arising from fraudulent financial reporting also may be present when misstatements arising from misappropriation of assets occur (for example, ineffective monitoring of management and weaknesses in internal control may be present when misstatements due to either fraudulent financial reporting or misappropriation of assets exists).

Incentives/Pressures

Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets. (Access to assets, such as access to participant data communicated to the trustee, may be indirect.)

- Known personal financial pressures affecting employees with access to plan assets

Adverse relationships between the plan sponsor or plan administration and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:

- Known or anticipated future employee layoffs
- Recent or anticipated changes to employee compensation or benefit plans
- Promotions, compensation, or other rewards inconsistent with expectations
- Individuals involved in plan administration known to be dissatisfied

Opportunities

Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:

- A company sponsoring multiple defined benefit pension plans, some underfunded, some overfunded
- Lack of qualified outside service provider to serve as trustee and/or custodian of plan assets
- Nonreadily marketable, specialized, or unique investments and management's lack of understanding of such investments (for example, nonregulated investments such as hedge funds and "alternative investments", derivative products, securities lending arrangements, junk bonds, real

estate, securities traded in non-U.S. markets, limited partnerships, and real property)

Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:

- Lack of appropriate management oversight
- Lack of review of plan investment transactions including accounting for investment income (for example, by the trustee, sponsor, or the plan's investment committee)
- Lack of segregation of duties or independent checks
- Lack of independent preparation and review of reconciliations of trust assets to participant accounts or accounting records of the plan
- Lack of segregation of duties related to benefit payments, contributions, investment transactions, and loans
- Plan administrator does not maintain independent records and periodically check information provided to the custodian
- Lack of appropriate system of authorization and approval of transactions
- Lack of complete and timely reconciliations of assets
- Lack of approval of transactions with parties-in-interest that could lead to prohibited transactions
- Lack of timely and appropriate documentation for transactions
- Trustee does not prepare required supplemental information (for example, historical cost records not maintained for non-participant directed accounts)
- Lack of controls over benefit payments, including the termination of payments in accordance with plan provisions
- Lack of segregation of plan assets from the sponsor's assets or inappropriate access to plan assets by plan sponsor

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- SAS No. 70 report indicating a lack of adequate controls at an outside service provider
 - Use of a service provider that does not provide a SAS No. 70 report
 - Unreconciled differences between net assets available for benefits per the trustee/custodian records and the recorded participant accounts for a defined contribution plan (unallocated assets or liabilities)
 - Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation
 - Inadequate access controls over automated records, including controls over and review of computer systems event logs

Attitudes/Rationalizations

We may not be able to observe risk factors reflective of employee attitudes/rationalizations that allow them to justify misappropriations of assets. Nevertheless, if we become aware of the existence of such information, we should consider it in identifying the risks of material misstatement arising from misappropriation of assets.

If we have observed the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

- Disregard for the need for monitoring or reducing risks related to misappropriations of assets
- Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies
- Behavior indicating displeasure or dissatisfaction with the plan or plan sponsor or their treatment of the employee
- Changes in behavior or lifestyle that may indicate assets have been misappropriated

Governmental Employee Benefit Plans

Governmental Employee Benefit Plans

This section addresses audit and accounting issues unique to governmental employee benefit plans (governmental plans). Auditors of governmental plans should also see the AICPA Audit and Accounting Guides *Audits of State and Local Governments (Non-GASB 34 Edition)*, and *Audits of State and Local Governments (GASB 34 Edition)* and the AICPA Audit Risk Alert *State and Local Governmental Developments*.

Help Desk—The accounting for many governmental plans is prescribed by Governmental Accounting Standards Board (GASB) standards, primarily GASB Statements No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans* (the EBP Guide) and related AICPA publications (such as this Audit Risk Alert, the checklists, and Practice Aids listed in the “Related Publications” section of this Alert) are designed to address issues related to plans sponsored by commercial or not-for-profit private sector entities, and the accounting provisions in the EBP Guide do not apply to governmental plans. However, portions of those publications, including this Alert, may be useful to auditors of governmental plans. For example, auditors should consider referring to the EBP Guide for specific auditing considerations relating to governmental plans, such as evaluating actuarial information. Although the audit objectives for governmental plans are similar to those for private-sector pension plans, the auditor should be aware that the Employee Retirement Income Security Act of 1974 (ERISA) does not apply to governmental entities. Instead, state and local laws and regulations govern the operations of governmental plans.

Current Trends

The funding levels for public sector retirement plans have been reduced by three years of underperforming investment returns, and funding, like funding for all governmental programs, is threatened by lower tax revenues and governmental deficits.

A study of 199 public pension funds performed by Greenwich Associates revealed an average asset loss of 9.3 percent from 2001 to 2002, which followed an 8.9 percent loss from 2000 to 2001. As a result, the percentage of underfunded plans rose from 52 percent overall, and to 58 percent among funds with over \$5 billion in assets. U.S. equity markets fell for the third year in a row, which has not happened since the period 1939 to 1941. The S&P SuperComposite 1500 fell 21.3 percent in 2002 after falling 10.6 percent in 2001 and 7.0 percent in 2000.

Funding of benefit programs may be tested as state legislatures face a minimum \$68.5 billion budget shortfall for fiscal year 2004. According to the National Conference of State Legislatures, President Angela Monson, a state senator from Oklahoma, says, "Thirty-three states estimate budget gaps in excess of 5 percent, with 18 of those facing gaps above 10 percent. There is great cause for concern since the deficit numbers continue to grow at an alarming rate."

Audit Risks

With the continued investment losses and underfunding of plans, many funds have undertaken asset allocation or asset/liability studies. Auditors should consider reviewing such studies, including comparing allocation targets and ranges with the current asset allocation to determine if funds are within policy limits. Also, benefit cash flows should be monitored for any possible changes in contribution rates, early retirement incentives, and/or increased purchase service activity.

New and Proposed GASB Pronouncements

Help Desk—For further information on recent exposure drafts outstanding, visit the Web site <http://accounting.rutgers.edu/raw/gasb/welcome.htm>.

GASB Issues Standard to Improve Disclosures on Deposit and Investment Risk

In an effort to provide the public with better information about the risks that could potentially affect a government's ability to provide services and pay its debts, the GASB has published GASB Statement No. 40, *Deposit and Investment Risk Disclosures*, an amendment of GASB Statement No. 3. The Statement amends GASB Statement No. 3, *Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements*, and addresses additional risks to which governments are exposed.

The new accounting guidance requires that state and local governments communicate key information about deposit and investment risks, frequently one of the largest assets on a government's balance sheet. Under GASB Statement No. 40, state and local governments are required to disclose information covering four principal areas:

1. Investment credit risk disclosures, including credit quality information issued by rating agencies
2. Interest rate disclosures that include investment maturity information, such as weighted average maturities or specification identification of the securities
3. Interest rate sensitivity for investments that are highly sensitive to changes in interest rates (for example, inverse floaters, enhanced variable-rate investments, and certain asset-backed securities)
4. Foreign exchange exposures that would indicate the foreign investment's denomination

The provisions of GASB Statement No. 40 are effective for financial statements for periods beginning after June 15, 2004. Earlier application is encouraged.

Help Desk—GASB Statement No. 40 (product code no. GS40) can be ordered through the GASB's Order Department at (800) 748-0659 or online via its Web site at www.gasb.org.

GASB Issues Technical Bulletin to Improve Disclosures About Derivatives

In an effort to improve disclosures about the risks associated with derivative contracts, the GASB has released for public comment accounting guidance that would provide more consistent reporting by state and local governments. The proposed Technical Bulletin, *Disclosure Requirements for Derivatives Not Presented at Fair Value on the Statement of Net Assets*, is designed to increase the public's understanding of the significance of derivatives to a government's net assets and would provide key information about the potential effects on future cash flows.

While state and local governments use a vast array of increasingly complex derivative instruments to manage debt and investments, they also may be assuming significant risks. Governments must communicate those risks to financial statement users and the proposed Technical Bulletin would help clarify existing accounting guidance so that more consistent disclosures can be made across all governments.

Governments would be required to disclose the derivative's objective, its terms, fair value, and risks. The proposed accounting guidance would require governments to disclose in their financial statements credit risk, interest rate risk, basis risk, termination risk, rollover risk and market access risk.

Help Desk—This Technical Bulletin would be effective for periods ending after June 15, 2003. The proposed Technical Bulletin is available from the GASB's Web site. Comments on the proposed documents may be made through May 16, 2003.

Postemployment Benefits Exposure Drafts

The GASB issued two exposure drafts of proposed Statements on financial reporting of postemployment benefits other than pensions (known as other postemployment benefits, or OPEB) in February 2003.

- *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions.* This proposed Statement establishes standards for the measurement, recognition, and display of other postemployment employee benefits (OPEB) expense or expenditures and related liabilities in the financial reports of state and local governments.
- *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans.* This proposed Statement establishes uniform financial reporting standards for OPEB plans and would supersede the previously issued interim guidance in GASB Statement No. 26.

Other Governmental Employee Benefit Plan Resources

The National Conference on Public Employee Retirement Systems (NCPERS) issued a special report on the evolution of the structure of defined benefit and defined contribution plans in the public sector. The report is titled "The Evolution of Public Sector Pension Plans." The report details six examples of innovative state plans that offer variations of traditional defined benefit plans. The report also reviews the issues that have driven the discussion of defined contribution plans as well as the adoption of hybrid plans and the economic factors that have influenced the development of public sector plans. A copy of this special report has been sent to every NCPERS member. Additional copies are free to NCPERS members by calling the NCPERS office at (202) 624-1456.

Public Pension Coordinating Council's 2001 Survey of State and Local Government Employee Retirement Systems

The 2001 Survey of State and Local Government Employee Retirement Systems is available online at <http://ppcc.grsnet.com>.

The report presents summary statistical analysis of state and local government employee systems surveyed by the Public Pension Coordinating Council in the summer of 2001 and published in March of 2002.

Resources

See the “Information Resources” section of the AICPA Audit Risk Alert *State and Local Governmental Developments—2002* for a listing of resources for governmental entities, including governmental plans.

INFORMATION SOURCES

<i>Organization</i>	<i>General Information</i>	<i>Fax Services</i>	<i>Web Site Address</i>
American Institute of Certified Public Accountants	<i>Order Department</i> HARBORSIDE Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 (888) 777-7077	24 Hour Fax Hotline (201) 938-3787	http://www.aicpa.org
Financial Accounting Standards Board	<i>Order Department</i> P.O. Box 5116 Norwalk, CT 06856-5116 (203) 847-0700, ext. 10	24 Hour Fax-on-Demand (203) 847-0700, menu item 14	http://www.fasb.org
Department of Labor: Pension and Welfare Benefits Administration: Office of the Chief Accountant: Division of Accounting Services Division of Reporting Compliance Office of Regulations and Interpretations	(202) 693-8360 ERISA related accounting and auditing questions (202) 693-8360 Form 5500 preparation and filing requirements (202) 693-8360 (202) 693-8500		http://www.dol.gov/dol/EBSA

